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Real Estate Downturn of the Early '90s Differs from Today's Crash in Important Ways

Many market observers have pointed out similarities between the current downturn in commercial real estate and the downturn in the early 1990s. Both were preceded by an extended period of relaxed underwriting standards, excess capital chasing returns, significant cap rate compression, and steep increases in asset values. It is useful to compare and contrast key elements of the two periods in order to establish a reference point for today's investment strategies. Two key regulatory changes during the 1980s paved the way for the overbuilding that defined the 1990s recession in commercial real estate. The 1982 tax cuts included provisions that allowed for generous depreciation allowances and tax shelters for investors. Also during the 1980s, the deregulation of the savings and loan industry allowed these institutions to expand their investments to include commercial mortgages. The tax laws were changed again in 1986 to remove many of the earlier incentives for real estate investment. But the combination of a general atmosphere of economic recovery, an increasing appetite for real estate investment from institutional capital, and the introduction of the S&Ls as new and often inexperienced lenders for commercial real estate resulted in a massive oversupply of space in many markets. The silver lining in today's environment is a general lack of oversupply in most markets. New construction in nearly every sector has been below long-term trends, though some markets are struggling with oversupply problems. While ample financing was made available for development projects in recent years, the combination of supply constraints and sharply rising land and construction costs helped to keep new supply largely in check. The primary problem for commercial real estate today is a lack of demand, caused by an economic recession that includes significant job losses, a historic decline in consumer spending, a global slowdown in import and export activity, and the collapse of the residential housing market. The recession is reaching all property types, and vacancy rates are expected to approach or surpass 20-year highs. The lack of financing for new construction will likely keep new supply further constrained for some time, helping to improve real estate fundamentals as the economy recovers over the next few years. The collapse of the commercial real estate market in the 1990s led to the passage of the Financial Institutions Recovery, Reform and Enhancement Act (FIRREA) of 1989. That legislation, aimed at bailing out the savings-and-loan industry, established the Resolution Trust Corp. (RTC), which was charged with efficiently selling off the enormous quantity of bad commercial mortgages from failed financial institutions. The RTC took over distressed assets from failing lenders and owners and facilitated a quick and painful write-down. The RTC forced the clearing of defaulted loans and helped to establish pricing, which allowed transaction activity to recover relatively soon after the market collapse. Once clearing prices were established, private capital moved in rather quickly, accelerating the bottoming-out process and eventual recovery. In contrast, today there is little pressure from the government on the banks to mark their real estate portfolios to the market level. A series of plans and programs aimed at dealing with distressed assets, including the Troubled Asset Relief Program, Term Asset-Backed Securities Loan Facility, and the Public-Private Investment Program, have helped to avoid financial catastrophe. But these initiatives have had minimal impact in terms of actually addressing the distressed assets that were central to the financial crisis. Most lenders are not willing to foreclose on troubled properties primarily because their balance sheets are already impaired to

the extent that they generally lack sufficient capital to support significant write-downs. Some lenders and special servicers are playing “pretend and extend” as they extend loans to buy time rather than pursue foreclosures and take mark-to-market losses. As a result there have not been as many distressed transactions as market experts anticipated. Real estate financing leading up to the 1990s recession was fairly simple. Life companies, pension funds and commercial banks provided the bulk of funding and held mortgages on their balance sheets that matched their long-term liabilities. In the wake of the 1990s collapse of commercial real estate, these traditional lenders pulled back sharply, focusing their capital on the refinancing of existing assets. Eventually, new capital began to flow into the market to take advantage of distressed pricing, with valuations falling between 30% and 50%. Capital came from opportunistic investors and later from a revitalized REIT industry buoyed by tax reforms. The same FIRREA law that established the RTC also helped pave the way for the development of the commercial mortgage-backed securities (CMBS) model, which revolutionized real estate finance. Because of the risk-adjusted capital requirements that FIRREA placed on financial institutions, they were encouraged to hold securitized assets rather than whole loans. Bankers eventually modified the long-standing residential mortgage-backed securities (RMBS) model to apply it to commercial real estate assets, opening up another new financing source. The demand for CMBS encouraged investment banks and conduit lenders to originate massive volumes of new loans. A new moral hazard in the model emerged because CMBS loans are not held on the originator’s balance sheet, causing reduced incentives for rigorous underwriting. Competition among lenders led to increasing loan-to-values and lower pricing, which helped fuel the sharp spike in real estate prices. In addition, borrowers looking to minimize financing costs and equity contributions often supplemented senior mortgages with an increasingly complex array of subordinate financing, including mezzanine and preferred equity positions. The complexity of the new capital structures, especially for CMBS pools, has created a nightmare for workout situations. In the last downturn, the workout mechanism was relatively simple, primarily involving a single lender and borrower. Today, the complicated capital stack makes sorting out the interests of the different players more complicated, time-consuming and expensive. With competing interests of the various tranches engaged in tranche warfare, it is even more challenging to form an agreement in the restructuring process. Over the past 15 years, commercial real estate has been increasingly accepted as a mainstream asset class by large pension funds and other financial institutions. The market value of the NCREIF Property Index, which tracks institutional investment in U.S. commercial real estate, surged by eight-fold, rising from \$41 billion in 1994 to \$328 billion in 2008. While recent investments by institutions, particularly those at the top of the market in 2006-2007, have likely suffered declines in value, they often have the financial capacity to support their investments through additional capital. In short, these institutions can help to extend or restructure debt to avoid foreclosure. We believe that this is another reason that we have seen relatively little in the way of distressed asset sales. **(National Real Estate Investor/David Lynn)**

Bank Regulators Back “Extend and Pretend” Policies for Commercial Real Estate

On October 30, federal bank regulators issued guidelines that allow lenders to continue characterizing a loan as “performing” despite a decrease in the value of the

property below the amount of the loan amount. According to the FDIC press release, the policy statement “stresses that performing loans, including those that have been renewed or restructured on reasonable modified terms, made to creditworthy borrowers will not be subject to adverse classification solely because the value of the underlying collateral declined.” Banks have been postponing losses on troubled loans by extending mortgages upon maturity, a practice known by many in the commercial real estate industry as “extend and pretend.” The new rules are an acknowledgement of the concerns of many bank regulators that increasing defaults of commercial real estate loans could lead to a repeat of the financial crisis by forcing banks to suffer billions of dollars in losses. The explicit federal guidance essentially supports these bank practices, provided that the financial institutions are restructuring the loans in a prudential manner. As stated in the FDIC’s release, banks that “implement prudent loan workout arrangements after performing comprehensive reviews of borrowers’ financial conditions will not be subject to criticism for engaging in these efforts, even if the restructured loans have weaknesses that result in adverse credit classifications.” NAIOP and its real estate allies have been raising concerns with Congress and federal regulators on the lack of credit availability for commercial real estate since the financial crisis began in late 2008, specifically warning that the coming wave of commercial loan maturities could reignite problems in the banking sector and harm efforts at economic recovery. According to the FDIC, the new policy guidance “recognizes that during these difficult economic circumstances, continued credit availability to businesses, especially small businesses, is challenging, even where borrower performance has been acceptable.”
(NAIOP)

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Company Announcements Help Establish Base for Job Growth in Metro Denver

In Metro Denver, numerous company announcements over the past several months reflect the region’s strong business climate – even during recession – and will help establish a base for job growth as conditions improve, according to data compiled by the Metro Denver Economic Development Corporation (Metro Denver EDC) in its Monthly Economic Summary for November 2009. Data on U.S. gross domestic product (GDP) released in October suggest the U.S. economy – with significant help from government stimulus programs – may have emerged from recession in the third quarter. While GDP growth is a positive development, several substantial challenges remain for a full recovery. Labor markets remain weak, and consumer optimism is low as households struggle to balance poor income potential with the need to manage debt and restore savings. Additional challenges are also ahead for commercial real estate and the recovery taking shape in housing markets is still fragile. Last, the economy’s ability to maintain momentum without government support remains in question. “These challenges, however, are not necessarily cause for despair,” stated Patty Silverstein, chief economist for the Metro Denver EDC and president of Development Research Partners. “Improvements in labor markets and commercial real estate historically lag growth in output (GDP), so the current distress in these segments should slowly give way to improve trends as GDP strengthens.” Better labor markets will help improve household income, and several more quarters of increasing home sales could help home prices grow. This slower-than-average recovery will require some patience, but positive signs are already emerging. Metro Denver’s unemployment rate fell from 7.3 percent in August to 6.9

percent in September, and the statewide rate fell from 7.1 percent to 6.7 percent, compared to 9.5 percent nationwide. While most consumers grew increasingly pessimistic in October as a difficult labor market weakened consumers' assessment of business conditions and their income potential, consumer outlooks in two U.S. regions – one of which was the Mountain Region – actually improved over-the-month, according to the Conference Board's U.S. Consumer Confidence Index. Existing home sales in Metro Denver declined slightly (-1.5 percent) between August and September, but the market nonetheless showed other signs of improvement. September, for example, was the first month in nearly two years in which average sales prices for single-family homes and condominiums both increased on an over-the-year basis. Redevelopment activity is in full swing at the former StorageTek campus in Louisville, according to spokespeople for Houston-based ConocoPhillips. The company began demolition last November and recently completed its efforts to recycle and remove old material. Company officials say the finished buildings could be occupied in 2013. The company's long-term employment estimates for the campus suggest it could house as many as 7,000 workers. Additionally, the Colorado Renewable Energy Collaboratory's Solar Technology Acceleration Center (SolarTAC) recently broke ground at the Aurora Campus for Renewable Energy. Spokespeople say the 74-acre facility for solar testing will be one of the largest of its kind nationwide. As energy development progresses throughout Metro Denver, the region continues to attract new energy businesses. Spokespeople for San Francisco-based SunRun Inc., for example, say the company will begin operations in Colorado. SunRun – which already operates in California, Massachusetts, and Arizona – will launch a solar panel lease program that allows homeowners to purchase electricity from panels kept on their property. German company SMA Solar Technology AG said it will begin U.S. operations with a new manufacturing plant in Denver. The company has a 40 percent share of the global market for solar inverters. Spokespeople for the company say the new location in Stapleton will house roughly 300 workers, and the company could temporarily employ another 400 to handle busy periods. Metro Denver's educated workforce, transportation infrastructure, and emphasis on renewable energy were key factors in their location decision, as was Colorado's relatively low cost of doing business. A second German renewable energy company – SGB USA, Inc. – is also planning to launch operations in Metro Denver. The company manufactures wind turbine components for companies including Vestas Wind Systems and will locate its facilities and six employees in Wheat Ridge. Six economic indicators for Metro Denver moved positively this month, compared to eight indicators in the previous report. Two indicators moved in a positive annual direction in this month's and last month's report. The Monthly Economic Summary provides a snapshot of metro area economic activity, as well as its relationship to national and regional economic trends. Key highlights include:

Labor and Employment

- Metro Denver employers cut 3,500 jobs in September, a month in which employers have typically added 3,000 or more positions. On an over-the-year basis, Metro Denver employment declined the most in natural resources and construction (-17.2 percent) and professional and business services (-7.2 percent).
- An average of 2,400 claimants filed for unemployment insurance in Metro Denver during each week in September. The September weekly average was nearly 64 percent higher than the average from September 2008, and the average weekly

claims count for the first nine months of 2009 was almost 83 percent higher than the average for the same months last year.

Consumer Sector

- A 9.2 percent drop in Metro Denver retail sales between June and July was essentially consistent with seasonal norms, although July sales in each of the region's seven counties remained substantially below levels from prior years.
- Metro Denver hotels continue to report weaker-than-average occupancy trends. September's occupancy rate of 66.1 percent was seven percentage points below the occupancy level reported in September 2008. The September 2009 average room rate fell 14 percent below last year's average.
- August was the second consecutive month of over-the-year growth in passenger traffic at Denver International Airport. The August 2009 passenger count of nearly 4.9 million exceeded August 2008 traffic by more than 100,000 passengers.

Residential Real Estate

- The first-time homebuyers' tax credit helped drive a September spike in U.S. existing home sales. According to the National Association of Realtors (NAR), September sales rose 9.4 percent from August and were 9.2 percent higher than sales from September 2008.
- Metro Denver new foreclosure filings declined over the month. The drop primarily reflected slower foreclosure activity in Adams County and the City and County of Denver, and filings also declined over the month in Douglas County and the City and County of Broomfield.
- Metro Denver builders applied for a total of 417 permits throughout September for a 48 percent increase from the prior month. Even with the increased activity, total new permits through the first nine months of the year fell almost 63 percent below the rate in the same months of 2008.

Commercial Real Estate

- CB Richard Ellis' third quarter MarketView report for Metro Denver relayed that cycles in commercial real estate tend to lag cycles in the broader economy. Given this relationship in trends, forecasters expect Metro Denver's office market to deteriorate for several more quarters until demand for and supply of space come into better balance.
- Grubb & Ellis' third quarter 2009 Office Trends Report notes a few positive developments in Metro Denver's office market but suggests that improvements in vacancy and rent could be at least a year away. The report describes a recent decline in sublease space as a positive sign that many property owners have finished cost-cutting measures.
- The third quarter 2009 Industrial Trends Report by Grubb & Ellis suggests Metro Denver's comparatively stable industrial market weakened in the third quarter. The active and growing renewable energy sector has helped boost industrial property activity in northern Metro Denver submarkets, but other submarkets have struggled with weak demand for incubator and flex space.
- The third quarter MarketView report also predicts Metro Denver's industrial market will be less-exposed to foreclosures thanks to its comparatively smaller debt burden. Still, lease rates have fallen well below the level that would promote development,

and build-to-suit projects will dominate what little construction activity is expected to occur in the near future. Despite these weak fundamentals, the report notes that Metro Denver's industrial market is outperforming other markets in the West.

- The MarketView report also shows the region's retail market deteriorating further. Vacancy and availability rates reached record highs in the third quarter, lease rates continued to decline, and construction activity waned. Retail foreclosures are also burdening the market, although some segments – particularly those driven by grocery and discount retailers – are faring better. Because the recession was particularly hard on consumers, the report expects a recovery in retail property markets will be considerably delayed.

- The most recent Retail Trends Report by Grubb & Ellis reports that Metro Denver retail vacancy rates rose in the third quarter to the highest level reported in more than 10 years. While grocery-anchored shopping centers have fared generally well throughout the recession, retail power centers and strip malls have suffered.

(Metro Denver Economic Development Corporation)

	CURRENT	1 MONTH PRIOR	1 YEAR PRIOR
FED FUNDS RATE	.25	.25	1.00
3 MONTH LIBOR	.27	.28	2.23
PRIME RATE	3.25	3.25	4.00
10 YEAR TREASURY	3.54	3.19	3.70
30 YEAR TREASURY	4.40	4.00	4.19