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Signs of Life Emerge in Commercial Real Estate Lending Market

Several positive developments appear to be emerging in the real estate capital markets, providing a glimpse of optimism as investor sentiment begins to rebound. Case in point: Simon Property Group, an A-rated blue chip real estate investment trust (REIT) with a strong balance sheet, issued \$650 million of 10-year unsecured debt at 10.8% in March. In May, Simon issued \$600 million of 5-year notes at 7%. The nation's largest shopping center owner issued another \$500 million of 5-year notes at 5.5% in August. Several other public REITs also were able to raise large amounts of both secured and unsecured debt financing. Meanwhile, the commercial mortgage-backed securities (CMBS) market has shown signs of life and spreads have narrowed. Commercial mortgage rates have tightened up. We believe these signs are pointing to a thawing in the real estate capital markets. As of November 2009, the average commercial mortgage rate ranged from approximately 7% to 7.2%. Spreads over the 10-year U.S. Treasury yield narrowed to a bandwidth of 370 to 430 basis points compared with 430 to 500 basis points three months ago. Mortgage spreads for core retail, warehouse, and office contracted by about 50 basis points, while spreads for apartment and hotel properties essentially held steady during the same period. For apartments, it can be argued that spreads were already tight. However, with delinquency rates on apartment properties rising sharply, lenders may begin to increase rates in the near term. As the riskiest sector, hotel mortgage rates remain relatively high. On the CMBS front, all tranches have rallied appreciably. Spreads on the AAA and BBB CMBX indices have narrowed by over 130 basis points and 1,500 basis points, respectively, over the past three months. We believe that both mortgage and CMBS spreads will continue to drift downward, albeit at a slow pace as real estate fundamentals continue to stabilize. Though the volume of commercial mortgage originations in the third quarter of 2009 was down 54% from the same period in 2008, there are hundreds of active lenders providing mortgages, albeit at more conservative terms. According to Real Capital Analytics, regional and national banks originated 44% of the total lending volume year-to-date through October, while international banks and insurers accounted for 10% and 13%, respectively. Lending standards and deal size also vary noticeably among these lenders, with insurers and international banks financing the largest deals on average. According to the Federal Reserve Senior Loan Officer Survey, more than 80% of domestic banks surveyed in the fourth quarter of 2008 indicated that they were tightening lending standards on commercial real estate loans. The October survey showed that only about 35% of banks reported tightening standards. Although the percentage of survey respondents who are tightening commercial real estate underwriting standards remains high relative to the historic average of 17%, the improving trend is clear. The \$400 million sale of new commercial mortgage bonds by U.S. mall owner Developers Diversified Realty (DDR) in early November generated strong investor demand. This issuance was the first transaction sold under the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF), which aims to lower funding costs for issuers by offering investors funding for the purchase of the securities. The deal was actually priced below existing levels for the CMBS issues. The \$323 million AAA-rated five-year notes came to a yield of 3.8%, and at a premium of 140 basis points to the five-year interest rate swap benchmark. We believe the tight spreads demonstrate that the market has a strong appetite for well-structured and transparent CMBS products of this nature. Several REITs, including Vornado Realty Trust and Inland Western Retail Real Estate Trust, are expected to

request funding through the TALF program for the origination of new funding. There is an estimated \$2.1 billion of new and legacy CMBS in the pipeline under the TALF program. Still, the amount is only a small fraction of the market need. We believe that this success could signal the beginning of the recovery for the private CMBS securitization market, which has been essentially non-existent since June 2008. In a nutshell, despite some improvements in the capital markets, commercial mortgage debt remains both expensive and difficult to obtain. We believe that the lending environment will continue to improve over the next year, including an increasing volume of CMBS originations. Those improvements will not, however, likely be enough to fully address the \$1.1 trillion of commercial real estate debt that will mature over the next three years (2010-2012). With underwriting requirements remaining tight, traditional balance sheet lenders under stress and reluctant to lend, and regional bank failures rising, we expect a continuing financing gap in the market.
(National Real Estate Investor/David Lynn)

Overwhelmed Special Servicers Ramp Up Distressed Sales

After months of waiting, opportunity investors are finally getting a break. Over the past 12 months, defaults on CMBS loans have jumped from less than 1% to nearly 9%. Overwhelmed with the sheer number of troubled securitized loans falling into their laps, many special servicers are opting to sell or liquidate the notes and underlying properties rather than work with borrowers to keep distressed loans alive. "When it comes to the investor community, we're hearing there's more and more meaningful engagement with special servicers as they continue to get overwhelmed and are clearly electing sale/liquidation strategies," commented Dave Warmund, a vice president for Trepp LLC, during a webinar titled "Distressed CRE Debt: Where are the Opportunities?" The presentation was delivered to an audience of investors and media on Tuesday. Trepp bases its research on mortgage and property performance of more than 80,000 CMBS loans representing approximately 100,000 properties with an outstanding balance of more than \$800 billion. The New York-based provider of CMBS and commercial mortgage information was selected by the Federal Reserve Bank of New York as a collateral monitor for CMBS as part of the Term Asset-Backed Securities Loan Facility (TALF) in June. To dispose of troubled loans, special servicers now favor liquidation strategies that include foreclosure, bankruptcy, REO, deed in lieu of foreclosure and note sales. Over the past 60 days, there has been an 18.3% increase in such strategies, representing 1,387 loans, up from 1,172. Meanwhile, over the same period strategies that focus on working with borrowers to cure distressed loans, including modification, resolution, extension and discounted payoff have increased by only 4.9% to 812 loans, up from 774. To identify where future loans in distress will originate, Warmund advises investors to look at the underlying debt-service coverage of loans as well as net operating income (NOI). "Regardless of whether loans are performing or not, there are 9,000 to 10,000 loans that have debt-service coverage under 1.0, or marginal coverage, many of which are not yet delinquent," Warmund explains. Moreover, there are almost 4,800 loans backed by assets with deteriorating NOI that have experienced 20% to 50% decreases in cash flow. "This represents a large pool of loans that will provide opportunity for distressed asset buyers," he says. Prospective buyers of distressed assets also will benefit as the dollar volume of loans that are experiencing changes in credit quality continues to grow, according to Trepp. In November, for instance, \$15.6 billion worth of CMBS loans were categorized as having deteriorating

delinquencies, and another \$14.8 billion were placed on a watch list. At the same time, some \$9.1 billion in loans were sent to special servicing and another \$3.4 billion had appraisal reductions. By property type, the greatest likelihood of opportunity for distressed buying can be found in the hotel and multifamily sectors. At the end of November, 17.3% of all CMBS-backed hotels and 13% of multifamily properties were in special servicing. In contrast, just 4.9% of office properties backed by CMBS loans had been turned over to special servicing, although that sector makes up 30.2% of all CMBS loans. Over the past two months, the Mountain region has recorded the biggest rise in the delinquency rate (10.4%), followed by the East South Central region (7.2%) and the West South Central region (6.6%). Despite the distressed asset concentrations in specific regions or markets, trouble knows no geographic boundaries. "Because of the granularity of the data at the loan and property level," Warmund notes, "there are likely opportunities in virtually any market." **(National Real Estate Investor/Sibley Fleming)**

CU Economist Wobbekind Sees Stability in Colorado, but No Growth, in 2010

Colorado's economy will stabilize, but not grow, in 2010, according to economist Richard Wobbekind of the University of Colorado at Boulder's Leeds School of Business. The state will lose about 3,200 jobs in 2010, compared with the 100,000 jobs lost in 2009, Wobbekind forecasts. Job losses will continue in the first quarter, before leveling off in the second quarter and moving into positive growth in the third and fourth quarters, he said. "We still have some serious kinks to work through, but we see 2010 as a stabilizing year that will put the state economy in a position for more sustained growth in 2011 and 2012," Wobbekind said in a statement. Wobbekind's forecast was part of Monday's 45th annual Colorado Business Economic Outlook Forum, hosted by the Leeds School of Business and BBVA Compass bank in downtown Denver. Colorado's unemployment rate likely will continue to rise despite weak job growth, because the growth won't be enough to absorb new entrants and people returning to the workforce, he said. The state's unemployment rate, estimated at 7.3 percent in 2009, will grow to 8.1 percent in 2010, Wobbekind forecast. But it will remain at least two percentage points below the national rate, which is projected at 9.5 percent to 10.5 percent in 2010, he said. "I think people will be disappointed to hear that we think there will be continued job loss in 2010, but in relative terms it will seem like we're in recovery because the job loss is very small compared to what has happened in 2009," Wobbekind said. It's not just one or two years of poor job creation — from an employment perspective, the years since 2000 can be described as a "lost decade" for the state, with only 117,900 jobs created while Colorado's population increased by 870,000 people, Wobbekind said. Retail sales are projected to grow by 3 percent in 2010, compared with a 12 percent decline in 2009. Meanwhile, the Denver/Boulder/Greeley Consumer Price Index, which functions as a statewide inflation gauge and is used to determine the state's minimum wage, will grow by 0.7 percent in 2010 after declining by 0.4 percent in 2009, Wobbekind forecast. **(Denver Business Journal)**

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Retail Investors Will Re-Enter Market in 2010

According to the Jones Lang LaSalle 2010 Retail Outlook, retail transactions and sales volumes are expected to increase as customer demand begins to gradually pick

up. Additionally, investors looking to make a purchase when acquisition prices are at their lowest are likely to find value in class A trophy shopping malls in 2010. An increase in sales volumes will be a welcome sign of recovery after the severe decline experienced in 2008 and the first three quarters of 2009. The JLL report states "retail property transaction volume fell 66% from total year-end volumes of \$56.3 billion in 2007, to a mere \$19.2 billion for total year 2008." Additionally, so far in 2009, not taking into account the November and early December numbers, transaction volume declined 71% from 2008, to \$5.6 billion. "The continued lack of liquidity in the debt markets has contributed to pent-up demand, and we expect opportunistic investors to cautiously re-enter the market in early 2010," says Kris Cooper, managing director in the retail investment sales practice. "We're just now seeing lenders' willingness to lend to strong sponsors open up, but those lending offers are at far more conservative levels than we've seen in the past." Still, this does not mean retail properties will begin trading at rapid rates. Highly-leveraged institutional investors are likely to hold on to properties unless forced to dispose of them because of pending debt maturities or of the need for capital. "Some buyers are coming around as many believe the bottom of the market has finally been reached," Cooper says. "Buyers will probably stick around for the next six to nine months before seeking better opportunities. We are also seeing significant interest from international buyers who feel now is the time to re-enter the US market." As a sign of better things to come, JLL cites its recent retail asset sales over the past three months. The retail investment sales team has completed roughly \$50 million in sales, including the \$17.8 million sale of the Arsenal Plaza in Watertown NY, a \$16.5 million sale in Southington, CT and a \$22.5 million sale in Lowell, MA. "Contrary to current conventional wisdom, we are experiencing growing demand for a wide range of retail properties. Supermarket-anchored properties continue to garner the most interest, along with other risk-averse single-tenant assets," says Jim Koury, managing director of the retail investment sales practice. "However, we are also seeing demand for non-supermarket anchored properties with credit tenants trade in a respectable mid to high to 8 percent cap ranges in select major metro markets. Developable land is also starting to garner interest as tenants, seeing an end to the downturn, start making 2010 to 2011 commitments for the choicest locations."
(Globest.com)

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The Money's There, Bring on the Properties

Private equity has returned to the market, but life support efforts—government and otherwise—are stifling deals and stymieing a quick recovery. This was the general sentiment at Knowledge@Wharton's second annual real estate forum, entitled "The Road to Recovery: Investing in the Global Real Estate Rebound." In the opening keynote interview, Starwood Capital Group's Barry S. Sternlicht set the tone of the day, expressing his discontent with the artificial stabilization of the market. "The US will lag in recovery because we don't have the leadership, nor the jobs to bring about a recovery," he said. Government initiatives, like TARP, are futile, he added, because they aren't truly addressing the dislocation in the market. If anything, these programs are protracting the pain, allowing deluded owners and banks to hold on to their underwater assets. Both the Federal Reserve and the Federal Accounting Standards Board, Sternlicht said, are further exacerbating the problem, keeping interest rates artificially low and relaxing write down rules,

respectively. "FASB recently said that if the appraisal of a loan is below the value, the debt doesn't have to be written down. That worries me," Sternlicht said. The investor questioned what the economic landscape would look like once the government safety nets are removed. "As the stimulus package wears off, there will be a further slow down, maybe a W-shaped recovery." Still, Sternlicht stressed that the market is re-equitizing, but there's limited supply of quality product and a host of buyers on the hunt. Private equity players are hovering around, but current yields on investment remains low, he said. But that's not stopping the hotel baron from making moves on the market. Sternlicht, who back in October led the consortium that picked up a 40% stake in Corus Bank's assets, has several active dedicated funds. "It's fun again to invest." That is if you have the money, and Sternlicht certainly does. His \$1-billion opportunity fund is taking a loan-to-own approach, while his \$1-billion REIT is employing what he called a loan-to-loan strategy, aiming to trade debt. Indeed, a number of panelists shared a predilection for both investment strategies—most notably real estate legend Sam Zell. "The debt markets provide optimum opportunity at this time," he told economist Peter Linneman, during an afternoon one-on-one session. "Over the next 24 months, everything that is currently held will be released at 20% to 25% lower than the original asking rate," Zell said. "At the debt levels out there now, nobody can afford to sell at true value." The industry-proclaimed grave dancer, who made a killing during the past couple of downturns, observed that this time around the deals just aren't there, yet. "As long as loans are kept current, no one will foreclose. And if banks don't foreclose, owners are not necessarily going to provide a deed-in-lieu," Zell said. "But as the banking system gets healthy, it's tolerance for out of sync loans will diminish accordingly." Both Zell and Sternlicht agreed that the global markets offer some sound investment opportunities, particularly Brazil. The South American locale, Zell pointed out, has a strong professional class and an inviting business model. The headliners also agreed that 2010 would not usher in a recovery. "All income-producing properties are going to have a hard 2010," Sternlicht said. "But 2011 and 2012 may look better."

(Globest.com)

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	CURRENT	1 MONTH PRIOR	1 YEAR PRIOR
FED FUNDS RATE	.25	.25	1.00
3 MONTH LIBOR	.25	.27	2.00
PRIME RATE	3.25	3.25	4.00
10 YEAR TREASURY	3.55	3.48	2.52
30 YEAR TREASURY	4.49	4.37	3.01