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REAL ESTATE INVESTMENT BANKING

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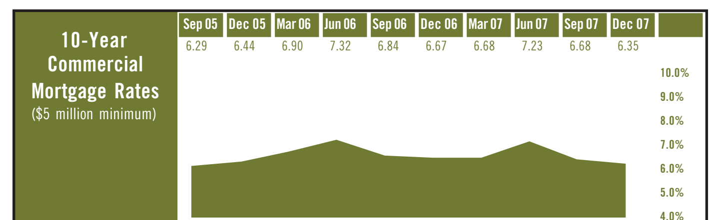
Liquidity, unfortunately, seems to be an illusion. It's there when you don't need it; it's not when you do. If liquidity is defined as the availability of capital, then today, we are liquid and flush with capital. The question that logically follows is: "Why is capital not flowing to U.S. real estate?" If liquidity is defined as the ability to execute a trade (the sale of the brick and mortar, the origination of loans, or the distribution of securitized bonds) in a market with no short term drop in value, then liquidity today does not exist.

The existence of a viable market is very different than the issues of pricing in a market that has a wide "bid–ask" gap. The market can deal with the vagaries and volatility of price only if buyers and sellers, borrowers and lenders, are free to transact. During this first quarter of 2008, a massive real estate resetting and deleveraging is occurring. Some say it is due directly to sub-prime and single family housing troubles. This is not entirely true. The commercial and residential markets are not linked but for three items: 1) space demand is linked by the health of the economy; 2) lending is linked through the capital markets; and, 3) bond pricing is linked through the investor base (supporting the capital markets). Otherwise, no other links exist. Commercial and residential issues are not at all intertwined. None of the flaws in the sub-prime business model are remotely present in the commercial real estate lending business. To the contrary, the strengths of the commercial real estate lending business model were not present in the sub-prime business model.

Bad news abounds from recent capital markets conferences in January and February that confirms for the time being, capital in enormous quantities has virtually evaporated for commercial real estate debt. This is an unfortunate wake up call as our industry needs to recognize that times have finally changed.

In 27 years in the business, I have never seen the market this bad. Life companies have money, but instead seem to be hoarding cash. Life companies last year did about $40B of business collectively. It is my view that life companies can in concert provide about $50B of capital to the industry. Since investor confidence is so low, and secondary market trades of bonds which are otherwise not selling are so rich, life companies in 2008 could, as a capital sector, do as little as $20B. Further, until a reasonable yield curve can be built on the bond side, the conduits are out of business. Conduits as a capital sector did $240B of business last year, and this year could be as low as $25B—with nothing really transacting until the fourth quarter. That means when we compare 2008 to 2007, $245B of capital has evaporated!



We haven't heard talk about "allocations to real estate", "allocations being cut", or "the denominator effect" from life companies in years. The industry as a result is normalizing in size. While this transformation is going on, allocators of investable capital are faced with enriched relative value investment decisions and challenges in a volatile pricing market.

We are encouraging all parties to shed their mental memory of the future and see things fresh. It is a new world out there; it is not 2006, it's not even the summer of 2007. If risk is defined as volatility of outcome, then these are indeed risky times. Investors fear immediate downside risk and see uncertain and unreliable upside. As risk is identified, assessed and priced to term (not just to execution), it is time to go back to the basics of structuring a deal for risk mitigation.

Currently, sales transactions between buyers with certain capital to deploy, and sellers interested and motivated to transact seem to be almost nonexistent. The market dynamics today remind us of 1986, when "old tax law" sellers were being approached by "new tax law" buyers. More than 20 years ago, it was almost as if parties were speaking different languages. As such, the "bid–ask" price on all assets hasn't been this wide in decades. Compounding the situation, as the business of real estate capital investing moves from a "storage business" to a "moving business", to a new business model somewhere between moving and storage, the way asset owners seem to be dealing with pricing volatility is by holding on and not trading.

We all need to consider the possibility that the industry overall has had too much capital driving through it and that

the industry is in the process of normalizing back to "an adequate level" of less than half the capital that flowed annually during 2006 and 2007. It is conceivable that the cost of capital will stay high and that half of the transacting companies, half the industry infrastructure and half of the esoteric nature of our business will go away. The cap rate game, the nominal risk to execution, is gone for the foreseeable future. As investor confidence remains low, as investors seek excess return on a risk adjusted basis, the relative value play is in place.

While we had hoped that life companies will fill a portion of the capital gap being created by conduits stepping aside, we were wrong. Life companies are asset allocators not market share focused.

This is a cry out to the borrowing community that the old world where lenders took equity risk for lender profit is gone. While no one has a view as to when this will return, we want borrowers to become aware of how different the capital markets reality really is. Maybe transactions have stalled because borrowers expect things to be better soon (back to "normal"); and they wait. We have entered a new world. It will be a long time before we see spreads below 200 bp over, or LTVs above 75%. We need a fresh look at the industry as it currently sits: over resourced, and (relative to 2006 - 2007) under capitalized. As it seems to be taking longer for the message to be heard, money is piling up on the sidelines; waiting to invest in a paradigm shift that includes a fresh look at risk and return.

	30-Day Commercial Paper	90-Day CDs	Corporate Aaa Bonds	Corporate Baa Bonds	Municipal Bonds
Nov 16	4.51	4.90	5.49	6.42	4.53
23	4.52	5.04	5.40	6.39	4.45
30	4.51	5.15	5.29	6.37	4.39
Dec 7	4.77	5.20	5.37	6.53	4.38
14	4.42	5.07	5.55	6.72	4.46
21	4.36	4.95	5.51	6.65	4.39
28	4.54	4.87	5.57	6.72	4.44
Jan 4	4.24	4.62	5.35	6.49	4.32
11	4.17	4.32	5.36	6.53	4.21
18	3.90	3.90	5.29	6.52	4.15
25	3.21	3.29	5.30	6.54	4.29
Feb 1	3.02	3.13	5.38	6.63	4.39
8	3.03	3.07	5.40	6.69	4.33

At Cohen Financial, we are not deterred and do have the relationships that can get attention to your financing needs. Today, transactions require (not unlike 15-20 years ago) a thorough brick and mortar discussion between parties about the risks and negotiated risk mitigants, which are then completely explained as part of a recommendation as to why an investor should participate in a transaction. A strong and knowledgeable financial intermediary can play a critical role in providing a capital markets solution.

The real estate asset class, for years an investment darling, now finds itself on the defensive—some fairly, but mostly for unrelated and unfair comparisons to other asset classes. While mistakes have been made, the most egregious one is that too many investors do not feel that they know what they have inside of and backing their current investments. We need to over prepare for the misinformed Q&A from public stock analysts and their well intentioned scrutiny of the financial institutions providing capital to our industry.

	Prime Rate	30-Day LIBOR	90-Day LIBOR	1-Year LIBOR	10-Year Treasury Securities	10-Year Swap Spreads
Nov 16	7.50	4.68600	4.90500	4.51300	4.17	0.7490
23	7.50	4.79300	5.04000	4.44000	4.01	0.8380
30	7.50	5.22500	5.12300	4.48800	3.95	0.6380
Dec 7	7.50	5.24200	5.14600	4.44300	4.02	0.6800
14	7.25	5.02700	4.99000	4.43800	4.17	0.6730
21	7.25	4.89600	4.88300	4.34700	4.02	0.6450
28	7.25	4.84500	4.83000	4.34100	4.20	0.6540
Jan 4	7.25	4.54000	4.64600	4.04100	3.90	0.6420
11	7.25	4.31900	4.37600	3.81200	3.89	0.6050
18	7.25	3.95875	3.92625	3.48000	3.64	0.6060
25	6.50	3.28500	3.24375	2.86250	3.64	0.6390
Feb 1	6.00	3.14375	3.11188	2.84938	3.64	0.6170
8	6.00	3.16500	3.09625	2.73000	3.73	0.6320

These rates are researched and posted daily at **www.cohenfinancial.com**—under Industry Resources, click on "Credit Market Report".

Much has been said about the potential loss of commercial real estate property value. We remind everyone that the assessment of cash flow remains the key. Real estate can be seen as an operating business and when we talk about the potential drop of value because of rising interest rates or that the lowering of LTV lending must increase cap rates; everyone must maintain focus on the importance of maintaining and driving increased cash flow. You can't buy, and you can't lend, anymore on a cap rate plan alone.

The industry old timers are constantly asked if our current industry woes are reminiscent of 1998 or even 2001. Our view is that this is more reminiscent of the early 1980's, the late 80's, and the early 90's. If we are correct, then we are reminded that the solution in the early 90's that took us out of a real liquidity shortage then was that new capital had to be brought into the market. We believe that new capital came in at that time due to the reality that, for the first time in 15 years, negative leverage disappeared, and positive leverage returned to the industry. Today, while increased interest rates and increased cap rates not only will increase the weighted average cost of capital but it will also take us to an environment of negative leverage. We posit that the industry doesn't need new or more capital. Rather, in 2008 we need old capital confident enough to invest. This is only possible if everyone stops pining for the easy lending days of 2006 and the first half of 2007 and accepts the new world we live in for what it really is—good for business! The dislocation of capital happened for technical reasons; let's not make this worse by eroding commercial real estate fundamentals. Accepting the shift is the fastest path to a new foundation of wealth creation.

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