

Financing Notes

December 2008

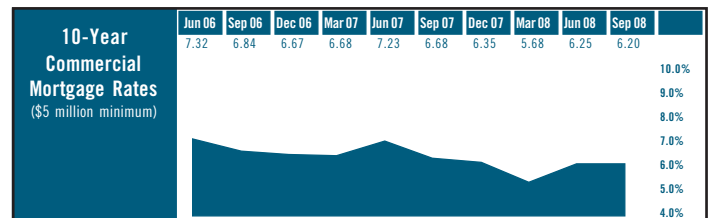
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We can't have a market again until we have a velocity of transactions. We can't have transactions until the banks are lending. We can't have banks lending to us until the banks lend to one another. The banks can't lend to one another until and unless they have confidence in one another. They can't have confidence in one another until their financial survival is ensured. So the Fed has taken action. And, with it, we have the Troubled Asset Relief Program (TARP). We need the "Drano" now to work. Greed, stupidity and the lack of oversight got us into this position. That and excessive internal and external leverage. Debt in the economy as a percentage of GDP was less than 50% in the 60's, 70% in the 90's and is 110% right now. The entire financial infrastructure of this country now has to de-lever. As financial institutions de-lever, so too will corporations, assets, and individuals. Yes, individual people will have to reduce their living costs and de-lever. People have been spending ahead of themselves, but these people will not have as many choices available to them to de-lever as corporations have. How one as an individual will de-lever if they lose their job (unemployment could go to 10% in 2009), after they have lost one-third of the value of their house (and all their equity), and depleted their savings base from their financial institutions will be an interesting conundrum facing us all.

The whole architecture of our financial foundation has changed over a few days and weeks while everyone has either been rescued, merged, or became a bank. The government has stepped in to guarantee the liabilities of certain banks while the Fed has stepped into the commercial paper market, guaranteed money market funds and moved to protect the life insurance companies. Now that protection is in place, confidence should have returned, but has not.

Volatility in the stock market and a clogged flow of capital is what we have experienced in the month of October. There appears to be little confidence and no trust anywhere, and you can't run a financial system without trust. We now have a government dominated market. At the same time we have growth in distrust in government. We speak of deleverage, but deleverage is a misnomer given the reality of the government debt for which taxpayers are now ultimately responsible. What we really have now is private-to-public movement of leverage ultimately yielding us a long-term public policy workout. What will be the long

term strategy for deleveraging the public sector? The Fed has stepped in and become a hedge fund and backed assets that really depend on inflation. The Fed will have to print money in order to avoid deflation and inflate us away. The next year will be about the mistakes we have made in rebuilding the financial system on the fly. The open question, besides who will become the next Treasury Secretary, is "how much regulation and oversight can we endure?" There will be no investment banks, and no longer the question of who to cover and who not to. A "cooler heads" question may be



what changes could be made and deemed temporary, and as such what to ultimately unwind or what to make permanent? Whether there is restraint or thoughtfulness will come to roost in the decisions our government will make over the next 6-12 months. The most frightening thing about all of this is that we got into this problem at peak employment with a solid housing marketplace. We will have to work to get out of this with neither in place or expected any time soon.

According to a recent IMF study, it takes 2 to 2.5 years for an economy to fully recover from a banking crisis. So when does the equity market trough? GDP trough? Earnings trough? Warren Buffet says to buy stocks and invest in American stocks now. Researchers, economists and analysts tell us that a lag decline in more cyclical sectors is consistent with other periods where financial crisis were preceded by economic weakness. PE multiples typically contract by 30-35% during previous market corrections. In the current cycle, multiples have contracted already by 40%. After a long period of stable economic growth, and rising financial prices, the market has entered a period of extreme disruption that has shaken investor confidence to its foundation. Uncertainty about the future is in turn driving a pronounced reduction in risk-taking by individual investors and institutional investors. Worried? We are rebuilding a financial system on the fly, we have never before seen this magnitude of volatility, and everyone is healing a credit crisis globally.

How we got here, no one really cared. Sure, moral hazard was a key ingredient, but borrowers and lenders were encouraged to undertake risky investments without appreciation for the consequences. Since everyone believed they could walk away from the investment if it didn't work out, TARP was put into place because we faced a budding financial meltdown that could send the whole economy into a severe depression. The treasury proposed TARP as a backstop to pricing for certain illiquid assets thus freeing up liquidity to be used in the broader economy. Yet, the question is asked "if capital costs don't actually reflect risks, how can markets efficiently allocate capital to the best risk adjusted opportunities?" Risk aversion is so high now that the credit markets seized and lenders now require huge spreads just to extend credit. Some firms got into liquidity problems and were forced to sell illiquid assets to raise cash; healthier firms were forced to write down their own holdings in the same assets to reflect the fire sale prices that less healthy firms were obliged to accept. This produced new liquidity problems for the originally healthy firms, forcing them to raise capital by selling assets and the process snowballed. The point is that the decline in values for financial firms were driven more by a forced fire sale in illiquid assets than by a true decline in expected cash flows from those investments.

Like the olden days, enterprise value and true value will be independent of leverage and capital structure. And those CEOs who heretofore took risk and were coveted because they did, will be shunned. The death of the defined benefit program will affect real estate as will capital and asset allocations and denominator effect issues. The coming year will be closer to the end but should we hit true distress, the blow up year will be 2010 as we begin the major CMBS battle and welcome possibly TARP II and TARP III.

2008	Prime Rate	30-Day LIBOR	90-Day LIBOR	1-Year LIBOR	10-Year Treasury Securities	10-Year Swap Spreads
Aug 15	5.00	2.46688	2.80438	3.21813	3.89	0.7470
22	5.00	2.47188	2.81063	3.17188	3.83	0.7080
29	5.00	2.48625	2.81000	3.20688	3.79	0.6800
Sep 5	5.00	2.48688	2.81500	3.18125	3.64	0.6840
12	5.00	2.48750	2.81875	3.13063	3.61	0.5970
19	5.00	3.18750	3.20375	3.35125	3.44	0.6140
26	5.00	3.70875	3.76875	3.98250	3.86	0.7180
Oct 3	5.00	4.04500	4.20750	4.02250	3.65	0.6600
10	4.50	4.51250	4.75000	4.23375	3.81	0.5890
17	4.50	4.27750	4.50250	3.97875	3.94	0.5720
24	4.50	3.25875	3.53500	3.50250	3.53	0.4370
31	4.50	2.85000	3.19250	3.28188	3.94	0.4580
Nov 7	4.00	1.76750	2.38750	2.84125	3.71	0.4170

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

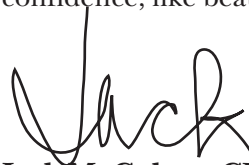
2008	30-Day Commercial Paper	90-Day CDs	Corporate Aaa Bonds	Corporate Baa Bonds	Municipal Bonds
Aug 15	2.03	2.78	5.68	7.17	4.67
22	2.05	2.80	5.58	7.11	4.64
29	2.04	2.80	5.54	7.09	4.68
Sep 5	2.03	2.79	5.49	7.01	4.62
12	2.03	2.79	5.46	7.05	4.54
19	2.29	4.06	5.63	7.28	5.03
26	1.99	4.14	5.91	7.66	5.23
Oct 3	2.05	4.75	5.96	7.86	5.36
10	1.65	4.94	6.12	8.25	5.47
17	1.62	4.82	6.47	9.09	6.01
24	1.47	3.88	6.32	9.29	5.32
31	1.19	3.45	6.42	9.49	5.35
Nov 7	0.82	2.65	6.37	9.33	5.24

Crisises in the 60's, 70's, 80's and 90's and again now have happened because individuals and institutions borrowed short and lend long. Consider the possibility that everyone's business plan going forward is a bust and now must change.

Sailors say that pessimists worry about the wind; optimists assume the weather will change; realists will trim their sails and move on. Skepticism and pessimism are not synonymous. Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive. The order of the day now however is a call to arms for the realists. No matter what happens going forward a lot more equity will be required. The equity will be more costly, banks will be fully integrated universal banks as in Europe and we will have more government regulation. The question is can we change and take all this on (new standards and reorganize) temporarily until cooler heads will prevail?

My conclusion is that to survive, and make no mistake, this is about survival, every owner of a business, every owner of an asset, has to develop his own ability to identify, assess and price risk. You not only have to know your business or your deal, but you have to own your own opinion and give up your mental memory of the future. Everything will be rebuilt based on what we have learned—who holds the risk, consolidation, long-term credit risk, loan to retain instead of loan to sell—among other things. It will be tough to nail the timing of this storm's end given the conflicting issues of term debt, large deals, homogenous assets, and construction loans. Volatility is here to stay. We are going to have to learn to live with greater uncertainty.

Two things affect price. Panic liquidity and intrinsic value. While commercial real estate is 10% of the current situation, and the government wants to bring back housing, the government believes that residential real estate has to be stabilized before we get to commercial. Land loans and repossession loans held by banks and dealers are a concern. Asset value on properties today is probably the debt (at best), not the real estate; and, whether or not people default or try to save the deal will be a by product of how much equity is at risk and whether or not people feel they want to protect it. The solution indeed is to shrink. Businesses, marketplaces, capital structure. People are going to have to have a conviction to play verses wondering when it will "feel right". Analysts are all over the life companies and the CIOs won't shift their mindset. So confidence, like beauty, will be in the eye of the beholder.



Jack M. Cohen, CRI, CMB
Chief Executive Officer