

Financing Notes

May 2009

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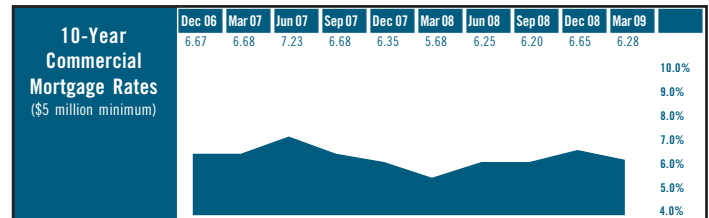
Do you think the collapse of the real estate market place is DETERMINISM (by design) or RANDOMNESS (everything means nothing)? We can not deny that we have experienced a “bubble”. A bubble merely transfers a share of the future demand into the present. It’s linked with dramatic valuations and always debt funded. It is this “bubble passing” that now forces us to all consider that our individual business plans need to change.

The day of reckoning has long passed its arrival industry wide; the time to take charge of our future is now. Our challenge is three fold: how do we forget everything we have learned; yet, exploit all of the skills we have accumulated from years of experience; and, give up our mental memory of the future? We as real estate practitioners need to take charge, we need to build, we need to buy, we need to invest; so, we need to ask ourselves: What will it take to get back into the game? How we will stay relevant until that time for each of us arrives?

Real estate as an asset class always was a worthwhile investment for three reasons: we were led to believe that it was a hedge against inflation; it was an asset that you could buy with leverage; and, that the combination of safe leverage and rental increases were in some way driven by the existence of job growth across our economy. In Q1 2009 the economy lost 1.9 million jobs and unemployment currently sits at 8.5%. Since 1939, our job growth over any 120 consecutive reporting months—a decade—has always been in excess of 12%. In January of 2010, we will acknowledge our own “lost decade” as there will be no effective job growth between January 2000 and January 2010. During the same time, we have added 13%–14% new office stock across the U.S. market place. This is clearly not good for the asset class.

Economists believe that unemployment will crest by the end of 2010. If history repeats itself, in 1986 and 1987 we had a valuation peak followed by financial crisis, followed by a political solution to the economic collapse. It wasn’t until 1994—eight years later—that the marketplace truly settled and began to grow. During 2006 and 2007 we had a valuation peak followed by extraordinary financial collapse and a political solution to this economic strife. If history repeats itself, we’re not back to a stabilized marketplace until 2014.

Accelerating or retarding the speed of recovery is the reality of a synchronized global recession. We have complications associated with a forecast of job loss or valuation loss due to the world’s increasingly interwoven economies and financial systems. As globalization speeds the flow of economic benefits in good times, in times of contraction, globalization transmits trouble with enormous speed and force affecting economies all over the world. Our economy shrank at a 6.3% pace at the end of 2008 which was the worst showing in more than a quarter of a century.



Unemployment rises, home values fall, and investment portfolios shrink so consumers cut back forcing companies to slash production and jobs. The U.S. consumer is 70% of U.S. GDP; the U.S. represents about 1/3 of the world’s GDP; therefore, the U.S. consumer is 20% of the world’s GDP. At the same time, we face growing protectionism sentiments across the globe verses our collective need to stay synchronized globally to get out of this recession. How do we get through the global recession that sees a great decrease in demand for all products let alone real estate space? When we emerge from recession to recovery, how do we have a sustainable path that makes good business decisions not just for one year, but for many years to come? If real estate is a “location” business, where is your business positioned to exploit the opportunities that 2009 and 2010 will bring forth?

A long period of healthy economic growth convinces people to take bigger and bigger risks. In the fall of 2008 former Chairman Greenspan insisted that the precipitating factor of the 2008 crisis was the failure to properly price risky assets. As you consider your play in this real estate cycle, consider your capacity to evaluate, analyze, identify, assess and price risk. You must consider the partners who have provided equity capital to your individual business plans as well. Without goal congruence as it relates to evaluation, analysis, identification, assessment and ultimate price of risk,

the proverbial rug is likely to get pulled out from under your business plan. It's bad enough that we stand on shifting sands vis-à-vis the regulatory ground rules that our government seems to be placing upon us. As we stabilize housing, fix the banking system, get credit flowing and re-regulate the financial markets—remember that hope and fear are inseparable. We need to ensure that those who provide the equity for America's deleveraging are in sync with the real estate owners and operators as to how they identify, assess and price risk. We believe that investors like risk (volatility of outcome) so long as they can price it; but, what investors hate is uncertainty—not knowing how big a risk is. Markets buy and sell risk that is wanted and unwanted.

Real estate is about risk shift and the market place is where this shift (for price) takes place. Today however, capital “markets” seem to be an oxymoron. We don't see capital flows returning to the levels we experienced in 2007. The combination of devaluation of assets, lower loan-to-value (LTVs) and decreasing velocity of transactional turnover should cover all but about \$50-\$70 billion of the capital needs of our industry. We don't see securitized mortgage lending returning until there is stability in the interpretation of mark-to-market valuation as well as sale treatment by the accountants on the balance sheets of our financial institutions. Pricing of course will be critical for the “new securitized world” given the volatility (risk that must be priced) heretofore bond buyers have experienced since June of 2007.

2009	30-Day Commercial Paper	90-Day CDs	Corporate Aaa Bonds	Corporate Baa Bonds	Municipal Bonds
Feb 6	0.42	1.16	5.29	8.18	4.96
13	0.44	1.12	5.21	8.01	4.89
20	0.47	1.20	5.25	8.01	4.89
27	0.47	1.16	5.31	8.13	4.87
Mar 6	0.41	1.14	5.40	8.23	4.96
13	0.42	1.17	5.49	8.40	5.03
20	0.40	1.04	5.62	8.50	4.98
27	0.37	0.96	5.51	8.53	5.00
Apr 3	0.45	0.98	5.41	8.47	4.92
10	0.37	0.96	5.47	8.58	4.92
17	0.32	0.89	5.32	8.40	4.78
24	0.32	0.87	5.33	8.26	4.57
May 1	0.34	0.79	5.46	8.26	4.70

Today, the market doesn't know what to expect. There is regulation uncertainty and there is a fear that regulation will change, leaving us regulation by deal. Can and will the government change the rules on the business community whimsically?

Money supply's effectiveness depends on how quickly people spend it—that is called velocity. If people hoard cash, velocity falls and more money is required to keep the economy moving. As velocity continues to fall faster than the Fed can pump up the money supply, our government must spend on goods and services. Yet Congress does not have its own stash. Every dollar it injects into our economy is taxed or borrowed out of the economy. Our

economy has stalled, with insufficient aggregate demand, with a decline in demand for goods and services, sales fall. Production is cut, people are laid-off, unemployment rises and declining profits further depress demand creating a vicious circle. We have to increase demand through consumption, investment, net exports and government purchases. Cheap credit, the usual route to recovery has failed to work. Lenders have pulled back; borrowers are focused more on paying down debt and building up savings. Keynesian economists advocate increasing government spending to combat economic downturns and generate jobs.

2009	Prime Rate	30-Day LIBOR	90-Day LIBOR	1-Year LIBOR	10-Year Treasury Securities	10-Year Swap Spreads
Feb 6	3.25	0.44750	1.24125	2.08875	2.90	0.2640
13	3.25	0.45500	1.23438	2.01875	2.72	0.2480
20	3.25	0.47313	1.25063	2.10125	2.86	0.2630
27	3.25	0.49688	1.26125	2.11500	2.97	0.3210
Mar 6	3.25	0.53313	1.28375	2.13625	2.82	0.2830
13	3.25	0.55625	1.32000	2.23000	2.89	0.1980
20	3.25	0.52313	1.22688	2.00625	2.59	0.3150
27	3.25	0.52250	1.23188	2.05250	2.73	0.2000
Apr 3	3.25	0.48938	1.16594	1.95500	2.75	0.2385
10	3.25	0.45125	1.13125	1.95125	2.92	0.2651
17	3.25	0.44688	1.10688	1.90625	2.82	0.1710
24	3.25	0.43750	1.09188	1.95000	2.92	0.1977
May 1	3.25	0.41125	1.01625	1.87688	3.09	0.2160

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

Motivations matter. Banks, whether they are local, regional or national interpret “troubled assets” and the use of TARP or PPIP money differently. “Toxic” to a local bank may be acquisition, development and construction loans for home builders while “toxic” for the largest banks in the globe may be mortgage securities. The motivations of banks differ from life companies (regulated by 50 different state regulators) which are different than the motivations of a securitized lender (and whether we are dealing with a trustee, a master, a primary, a sub, or a special servicer). In this market place knowledge matters, motivation matters, relationships matter.

Our future gets clearer every day. If our crisis was caused by a dramatic under pricing of risk, resulting from a combination of endless supply of capital and an insatiable appetite for leverage; then, our future is one of lower leverage, greater transparency, greater regulation and an organized marketplace where transactions are done responsibly. Regulation has the tendency to create accounting rules and capital requirements that aggravate financial retrenchment during a slowdown and financial access in a boom.

All real estate makes money; the only question is who owns it at the time.



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