

Financing Notes

January 2011

There is not a capital shortage; rather, capital is not in the right place always accessible for the right deals at the right time for the right reasons. What we have, therefore, is a distribution issue; where capital wants to go is not necessarily where it needs to go. It seems capital aggressively chases those deals that are leased, cash flowing, deemed to be low LTV, and “qualitatively attractive.” Rates—interest and cap—are now being priced based upon “scarcity value”.

The attractiveness of one investment relative to another does not come from what it’s called or how it’s positioned in the capital structure, but largely from how it’s priced relative to the other. The capital markets will always find the reckless bid. Today, we have a “Trophy vs. Trauma” marketplace. If your asset is leased, cash flowing, and at a low LTV, there is a feeding frenzy that drives a pricing bidding war. If one or more of those three criteria are not present, we have trauma. At some level, cap rates (which some view are related to interest rates) are no longer tied to risk, nor tied to return; rather they are tied to perceived scarcity value.

Investors today complain that they are experiencing their worst ever hit ratios. Too much capital, and no home for it, is putting pressure on investment dollars. Portfolio lenders in particular need income and yield with Treasuries priced at less than one percent. The number one issue that portfolio lenders face is rapidly declining investment income. Five- to six-percent assets are rolling off and being replaced by three- to four-percent earners. Corporate bonds are yielding almost nothing. If interest rates go up, a bond portfolio’s value goes down. If interest rates don’t go up, then everyone’s investment portfolios are inadequate. The challenge for the portfolio lender is clear: retool, cut expenses, and outsource until one figures out how to make profit in an environment of low investment income; and, at the same time, grow your business. Interestingly, this is no different than what the auto or the housing industries have had to address the past few years!

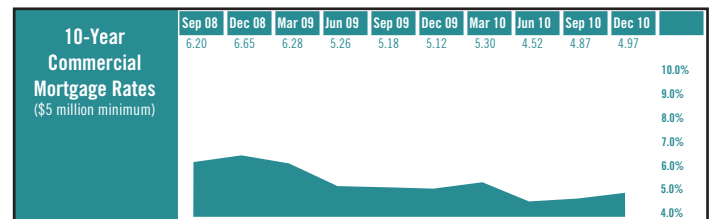
The run up in scale built by this country was too large. Housing was built up to 2.5 million new starts annually; it should have been 1.4 million; now it’s 500,000. In the auto industry, there was a high of 17 million autos sold in this country; but, in the first quarter of 2009, sales were at a 5 million car annual run rate; for the total year of 2009, 8 million cars and in 2010 it will be 12 million cars.

This country lost 8.5 million jobs since its peak in 2007, while we have gained back barely 850,000 jobs since the

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peak. Interestingly, during the Clinton administration’s best year we added 280,000 jobs a month. At that rate, it will take 26 months of Clinton’s best year to get back to peak employment. At a more reasonable average of 200,000 a month, it’s 38 months to peak. Given that the plan was that baby boomers would retire so that echo boomers could come into the job force; today we have both bubbles in the labor pool competing for the same set of jobs. Without employment, real estate space isn’t leased. Without leasing, values stay repressed. The problem is that while real estate income is generated locally, pricing is set nationally. Volatility is here to stay whether it is for capital funding or pricing.



We as a country need smart people helping to make real decisions, not overwhelmed politicians making populous decisions which favor local silo-ed agendas.

The Fed has successfully managed to get the risk premium out of the investment community’s pricing. But, municipal defaults are on the horizon as states and local governments have a trillion dollars of unfunded liabilities. Rainy day funds are depleted, pension fund contributions are at record lows, and most of the major federal government subsidy programs run out in 2011 as it relates to state and local government.

I can’t help consider the reality of 2006-2010 generationally—what does this mean for the real estate of this generation? Our parent’s generation had a mental and emotional “Depression Baby” logic embedded into their decision making thought process. By comparison, those of us who began our professional career in the early 80’s figured out how to respond to the crisis of the early 90’s. The flip side of that comparison occurs when we consider that the psyche of the generation that came into the business between 1993 and 1995 basically caused the meltdown of 2006-2007. In 2007 certain people saw where this crisis was headed and began to act. While few acted in 2007, most of the country saw 2008 as a shock to their system. As such, 2009 was about recovery from the abyss

and 2010 was about the transition to the new normal. Every generation tends to say that this time is different, when it never is. Yet this time is significantly different and may forever change our mindset about our jobs and careers, our approach to investment and savings, our view of how good or lucky we actually are.

The severity of the panic won't easily be forgotten. The developed world became heavily indebted. There was an orgy of leverage that eventually came to a reality, but not a solution. And, as a country and as investors, we continue to "kick the can" down the road. Slow growth, deleverage, suffering from recent investment catastrophe memories, Depression-kid-mentalities will drive the marketplace to less risk and more risk adverse, less leverage and more absolute return focus. Adaptation will separate the adults from the children as everyone will rethink their premised assumptions.

For the first time in many generations in this country there is a political risk. There's a lack of predictability, there's an intrusion by government, more regulation, and more populous sentiment. Everyone must see what has occurred and recognize the seriousness and adapt. But how? How do we cope with a new normal that has no development, slow growth and stagflation? How do we cope with a new normal that has so much selective capital that it's keeping interest rates and cap rates down? How do we cope when assets are priced and valued based on scarcity of capital or assets rather than historical, traditional, or forward thinking logical underwriting criteria?

Do we really develop a Depression generation psyche where home ownership is delayed as people would rather save and rent? Is this a boom for apartments as an asset class? Since the pace of recovery in output and employment will be slow, we will have high unemployment, modest income growth, lower wealth attributed to housing and tight credit. How will we adapt?

2010	30-Day Commercial Paper	90-Day CDs	Corporate Aaa Bonds	Corporate Baa Bonds	Municipal Bonds
Oct 1	0.20	0.27	4.52	5.58	3.84
8	0.20	0.27	4.56	5.59	3.84
15	0.21	0.27	4.71	5.74	3.82
22	0.20	0.27	4.71	5.76	3.84
29	0.20	0.27	4.77	5.80	3.96
Nov 5	0.21	0.27	4.75	5.79	4.02
12	0.21	0.26	4.90	5.95	4.24
19	0.22	0.26	4.98	6.03	4.72
26	0.21	0.27	4.90	5.95	4.60
Dec 3	0.21	0.30	4.90	5.95	4.65
10	0.17	0.29	5.03	6.09	4.86
17	0.20	0.30	5.08	6.18	5.15
24	0.20	0.30	5.01	6.10	5.00

Where will the jobs come from? Where will job growth happen—in education, in the medical field, in government? Jobs fill buildings. Sixty two-percent of all jobs go toward office buildings. But some consultants report that 65 percent of the leased office space is all that is needed. Per the author Michael Lewis, if the next generation is about the "Next New, New Thing", what tenant types will grow and need space? A reality for the real estate industry is real estate investments are granular. It's not like the stock market where you can "average in" your investment portfolio.

We have been told that \$500 billion was raised and invested between 2005 and 2008 on assets approaching \$2 trillion. All of them were reaching for returns and taking on risk that maybe they did or did not understand. Now, inside those investment funds there is no money for cushion and everyone is in a world of hurt. Everyone seems focused on the maturity bubble of the loans that are coming due over the next couple of years. Everyone seems focused on the extend-and-pretend on all the loans that didn't pay off over the last couple of years. I am troubled that no one really wants to talk about the losses that have to be taken on these investments that have happened between 2005 and 2008 before we can actually move forward as an industry.

2010	Prime Rate	30-Day LIBOR	90-Day LIBOR	1-Year LIBOR	10-Year Treasury Securities	10-Year Swap Rates
Oct 1	3.25	0.25625	0.29000	0.77775	2.52	2.6345
8	3.25	0.25625	0.28906	0.77150	2.39	2.4715
15	3.25	0.25625	0.28906	0.76650	2.49	2.6039
22	3.25	0.25625	0.28844	0.76650	2.53	2.6155
29	3.25	0.25406	0.28688	0.76400	2.66	2.7029
Nov 5	3.25	0.25344	0.28563	0.75600	2.48	2.6635
12	3.25	0.25344	0.28563	0.75906	2.65	2.8687
19	3.25	0.25344	0.28438	0.76325	2.90	3.0435
26	3.25	0.25344	0.28438	0.76313	2.76	2.9690
Dec 3	3.25	0.26563	0.30344	0.79000	2.99	3.0860
10	3.25	0.26219	0.30219	0.78250	3.22	3.3710
17	3.25	0.26063	0.30375	0.78513	3.47	3.5135
24	3.25	0.26063	0.30281	0.78325	3.34	3.4575

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

My mother's view about "minor" surgery is that it is surgery on somebody else. No one considers surgery on themselves as "minor". In that spirit, with real estate values off 40-60% from the peak, who will take the losses that need to be taken; and, how will they? Are they paper losses? Are they cash losses? In 2010, there were 600 fund managers. In 2004, there were only 200. Given everyone I meet is out in search of their own fund, will we have more or considerably fewer investment managers by 2012? If fewer, who gets consolidated?

There is not a capital shortage, there is a transaction shortage. At the beginning of December, Cohen Financial financed a \$25 million industrial portfolio at 3.5% interest-only for 5 years. When we asked a portfolio lender how they can make money on 3.5% interest rate investments, they compare it to investments in idle cash. Shouldn't the market tell you where to play? If you like commercial real estate and you want to be in the debt space, size or product should have something to do with your plan. Rather than comparing your investment to idle cash, why not reduce the reality of scarcity value and expand one's view of how, on what and where cash is invested?

I'm rooting for inflation.



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