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# Wall Street and Commercial Real Estate

Everett Allen Greer

December 15, 2010 – Los Angeles

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**Greer Advisors, LLC**

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**Los Angeles**  
**213.985.3800**

**New York**  
**646.867.1600**

**San Francisco**  
**415.233.6300**

**Dallas**  
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**Miami**  
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**San Diego**  
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# Goals of Presentation

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- Disclaimers
- Market Drivers
- Financial Regulations
  - Consumer
  - Real Estate
  - Securitization
- Wall Street and Capital Markets
  - REIT / MBS / CDO / CDS
- Expected Changes / Outlook
  - Securitization
  - Lending
- Greer's Forecast / Signs

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# Market Drivers

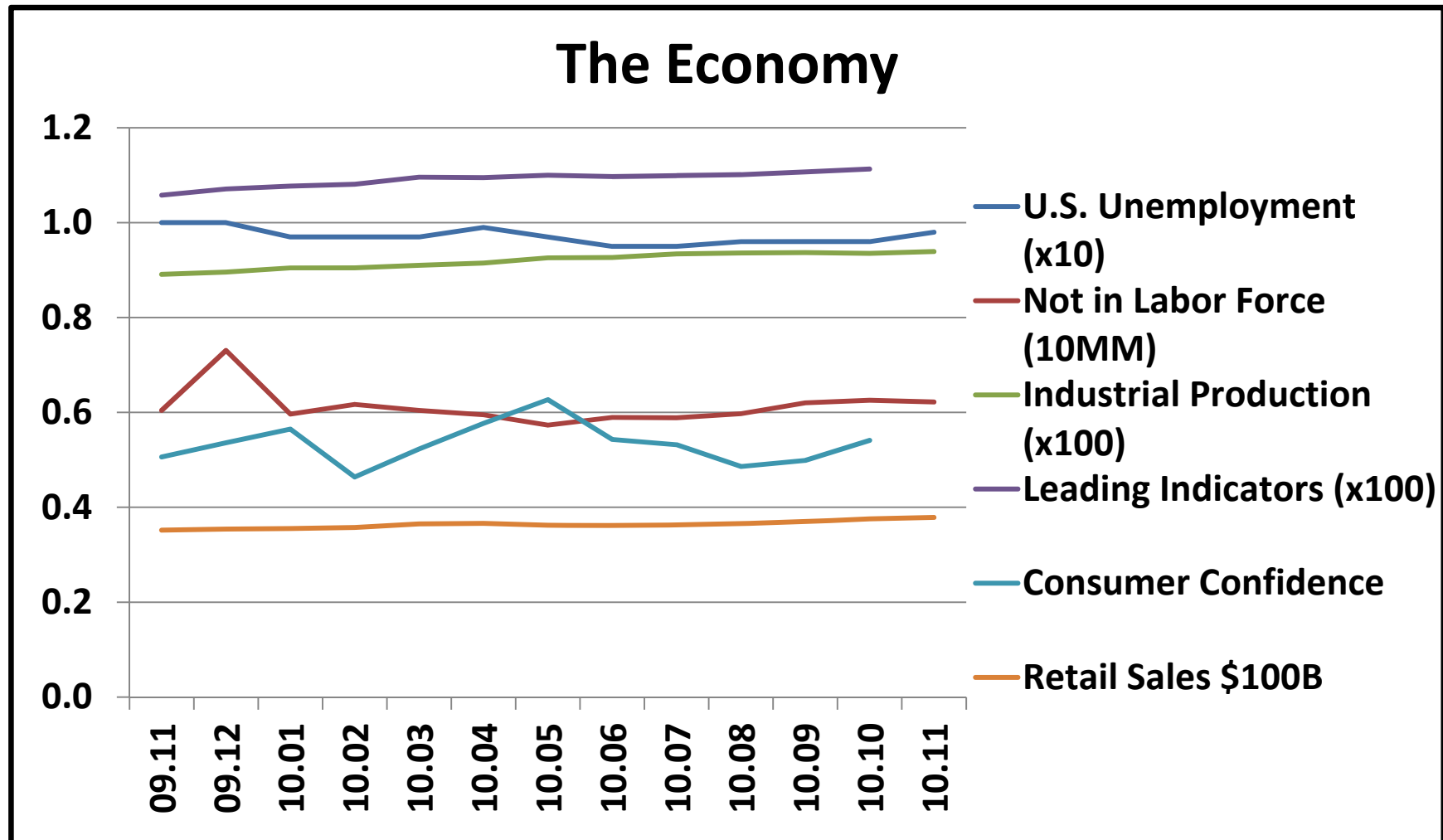
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**Supply / Demand** – Not as bad as early 90's

- Non-Res. Supply Growth was Very Limited Growth
- Most Demand ties to Gross Domestic Product
  - Office – FIRE Employment, Portion of Service Employment
  - Retail – Household Formations, Income Growth
  - Industrial – Manufacturing vs. Distribution
  - Multifamily – Households
  - Hotel – Corporate Travel – Office Employment
- Jobs & Retail Sales - Drive Supply & Demand!!!

**Financing** – **Currently Most Important Fundamental**

# The Economy - Flatline



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# Financial Regulations – Largely Unresolved

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## **Dodd-Frank Wall Street Reform & Consumer Protection Act**

- 16 Titles – See Summary on Wikipedia
  - 243 Rules to be created (about ½ done)
  - 67 Studies required
  - 22 New Periodic Reports
- Restructure of Regulators, elimination of OTS
  - Financial Stability Oversight Council (New)
  - Office of Financial Research (New)
- Keys for Commercial Real Estate:
  - Rating Agency Reform
  - Securitization Reform
  - Derivatives – minimal change

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- Wall Street and Capital Markets

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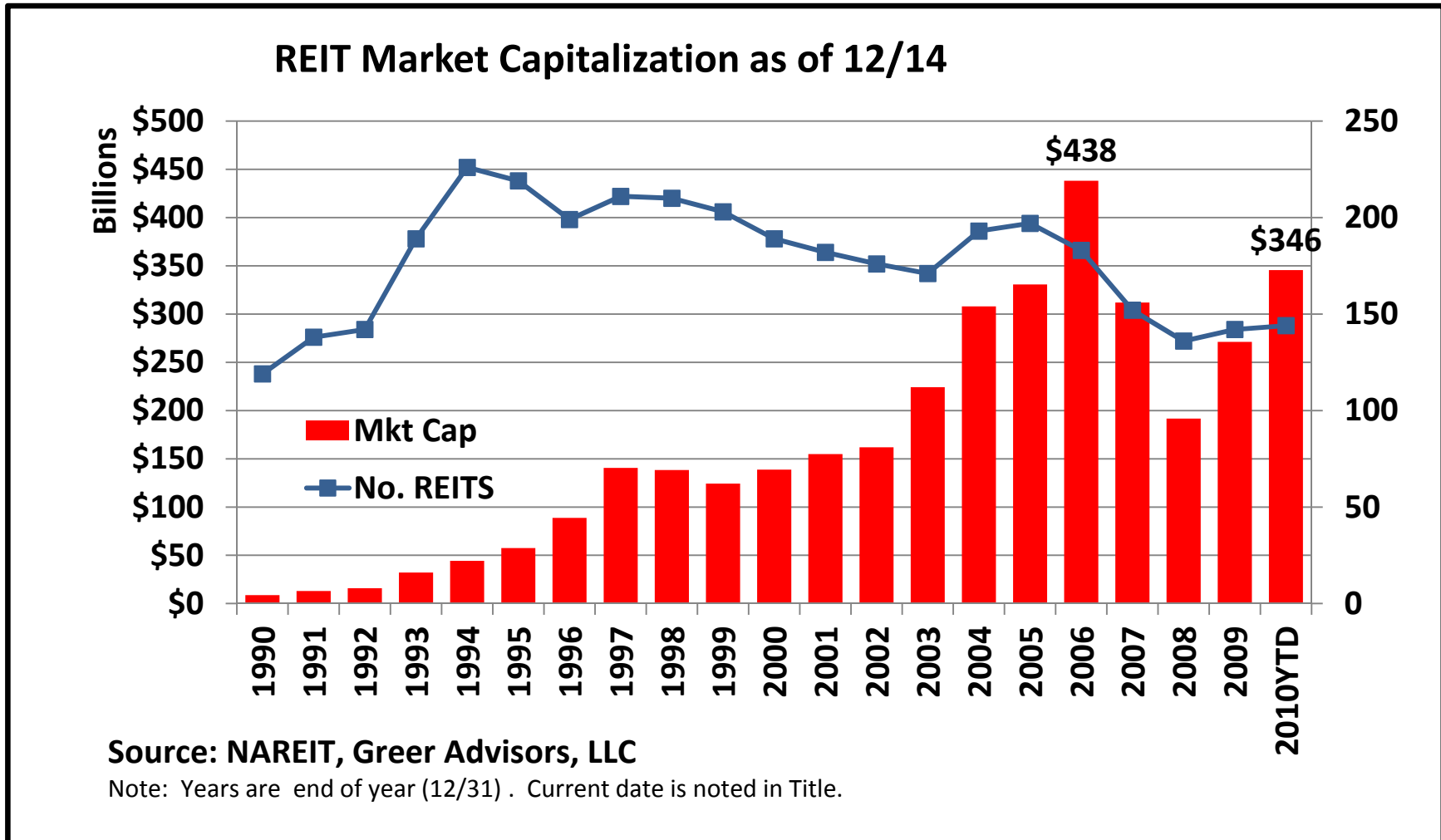
# What is REIT?

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## Real Estate Investment Trust

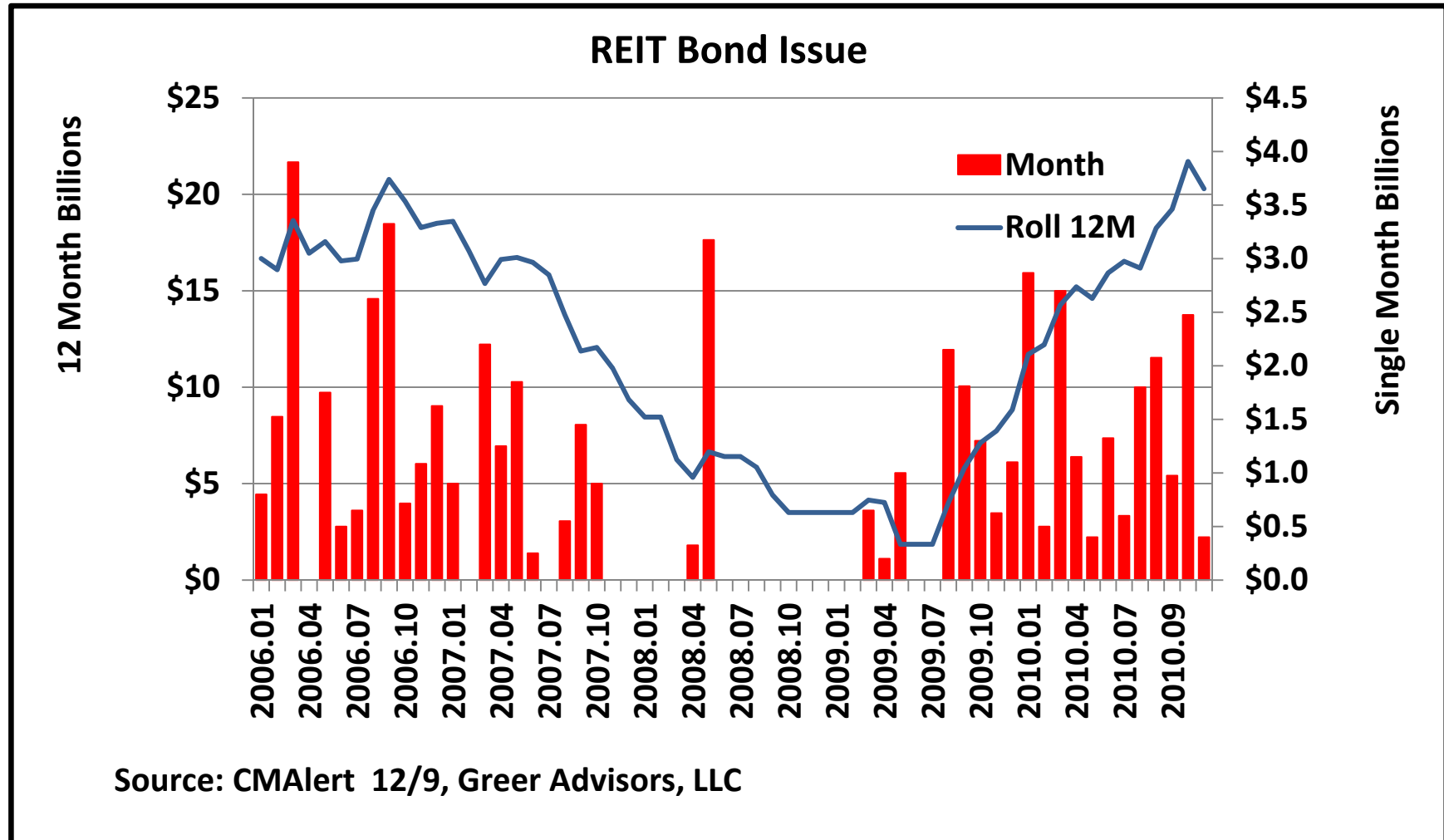
- Type of Pass-through Security
- Effectively a corporation
- As long as 90% of taxable income passed is through to shareholders, there is no “corporate” tax. All earnings are single-taxed at shareholder level.
- Current “Industry” Issues:  
Definition of Assets, Max Debt Load, Yield
- Note: additional rules include:
  - 95% of income must be from interest, dividends & property income
  - Minimum 100 owners, 75% of assets in real estate, 75% of income from rents or interest
  - no more than 20% ownership in other REITs, 5 owner rule on 50% of assets each ½ tax year (5/50)

# REIT Market Capitalization

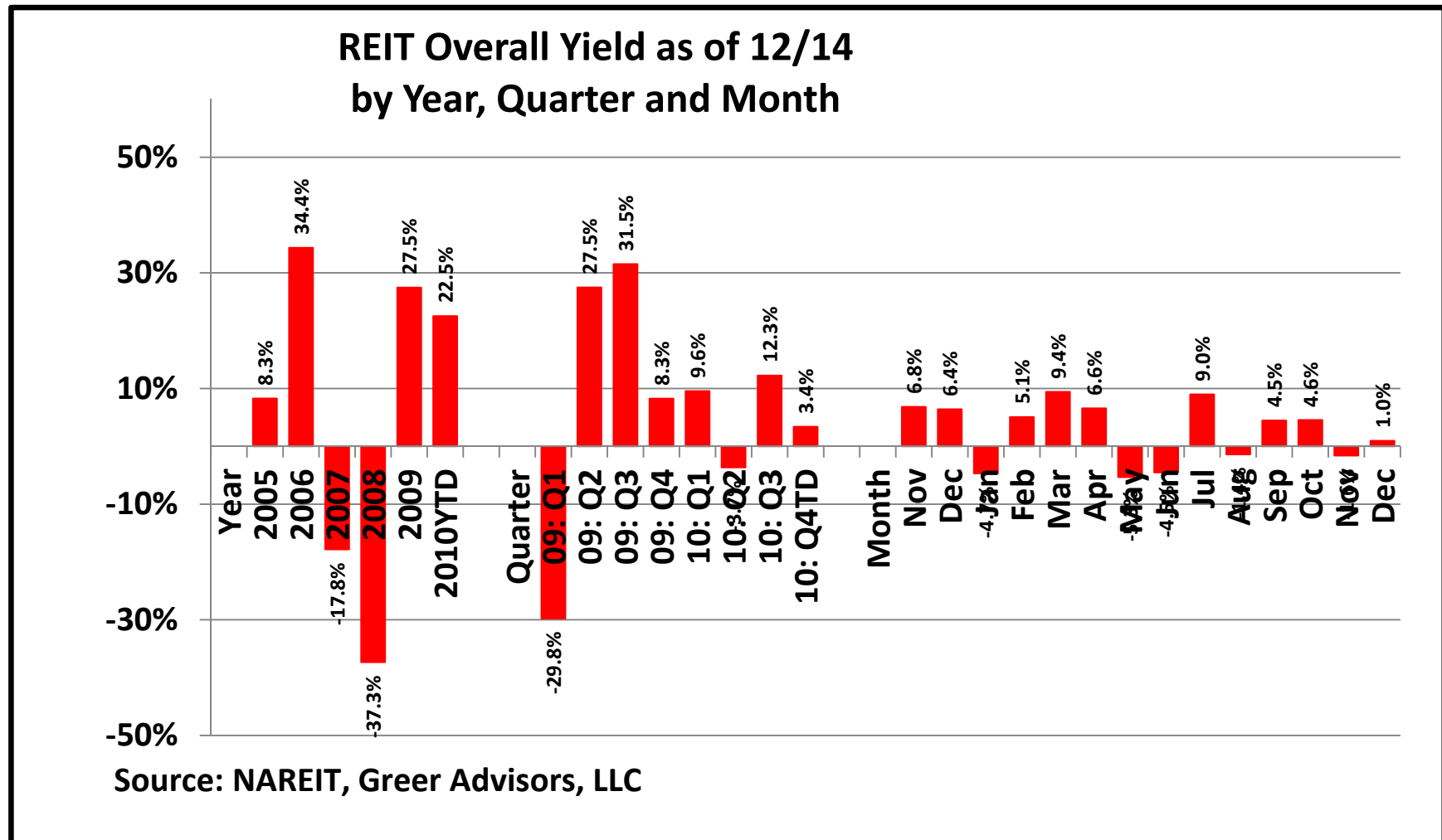




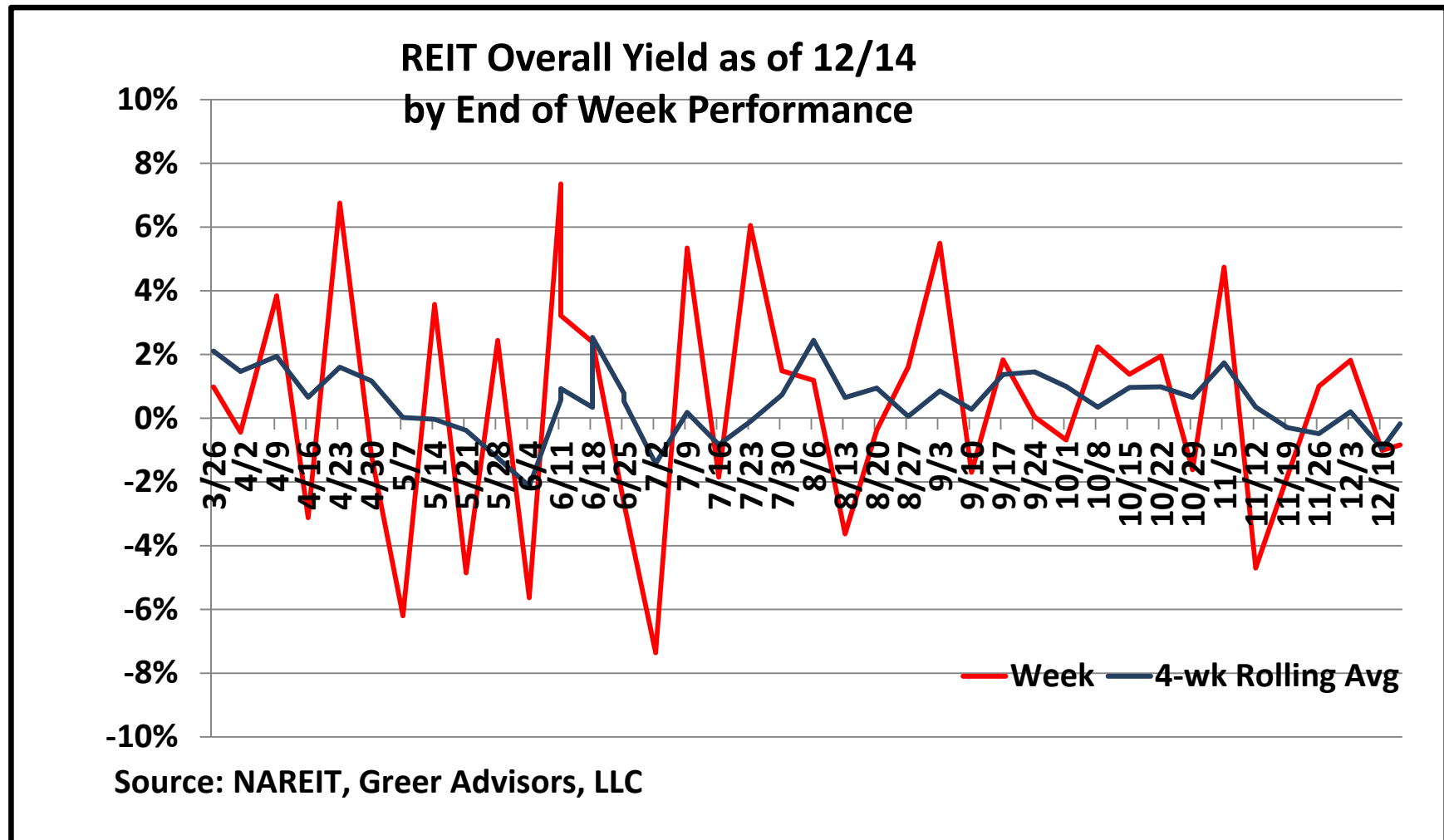
# REIT Bond Issue



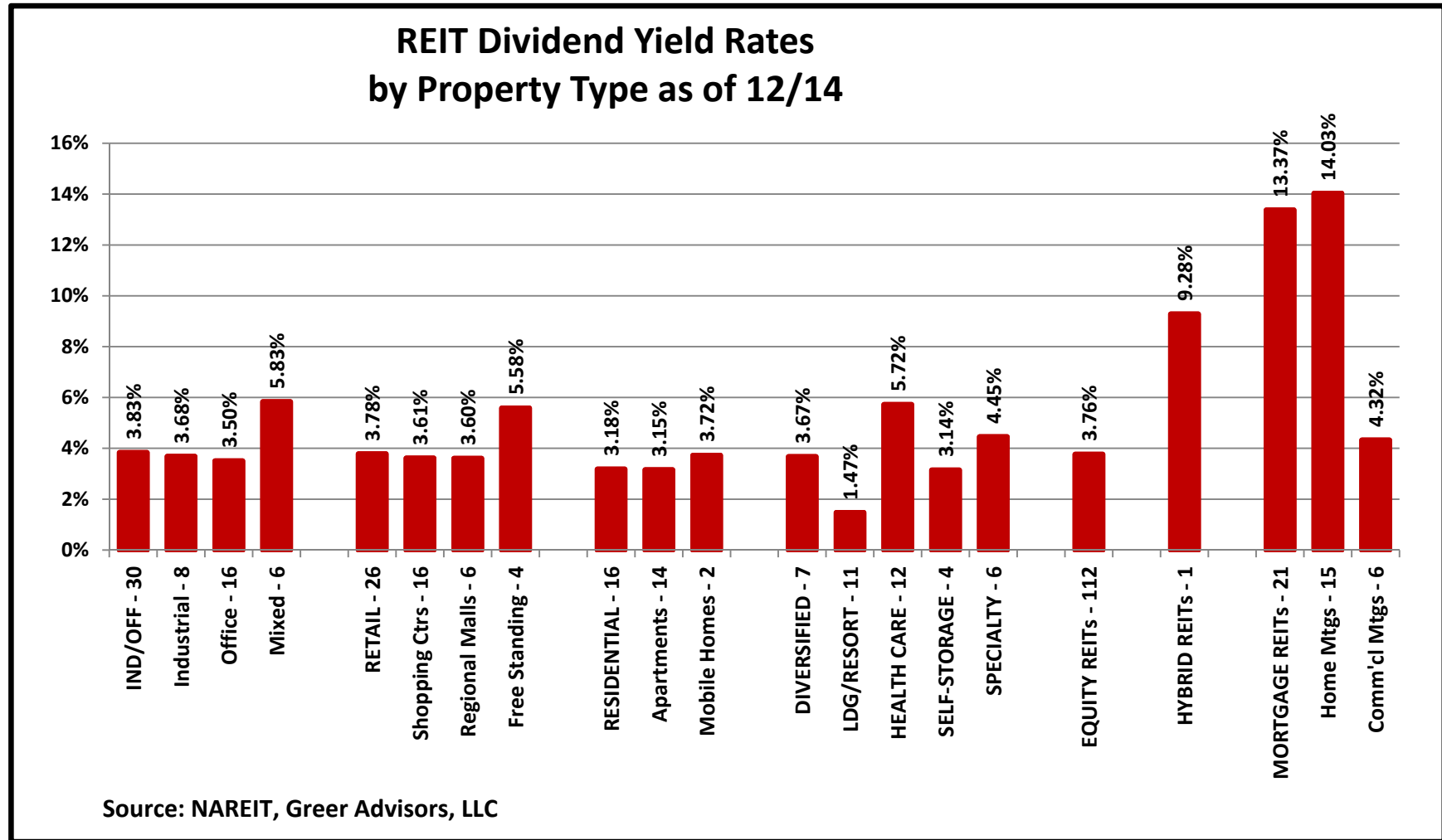
# Overall REIT Dividend Yields – History



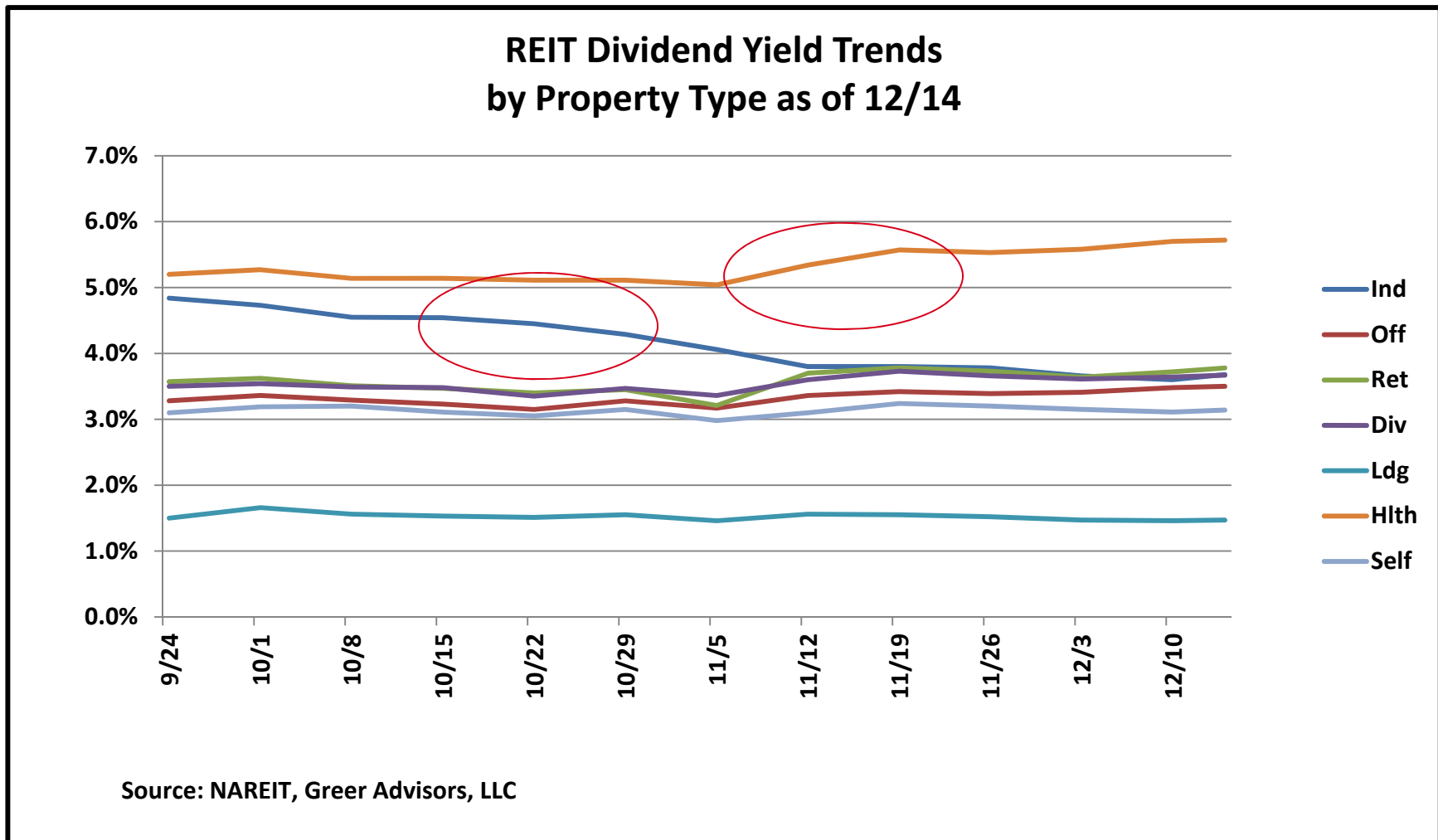
# Overall REIT Dividend Yields – Weekly



# REIT Dividend Yields by Property Type



# REIT Dividend Yields Prop Type Trends



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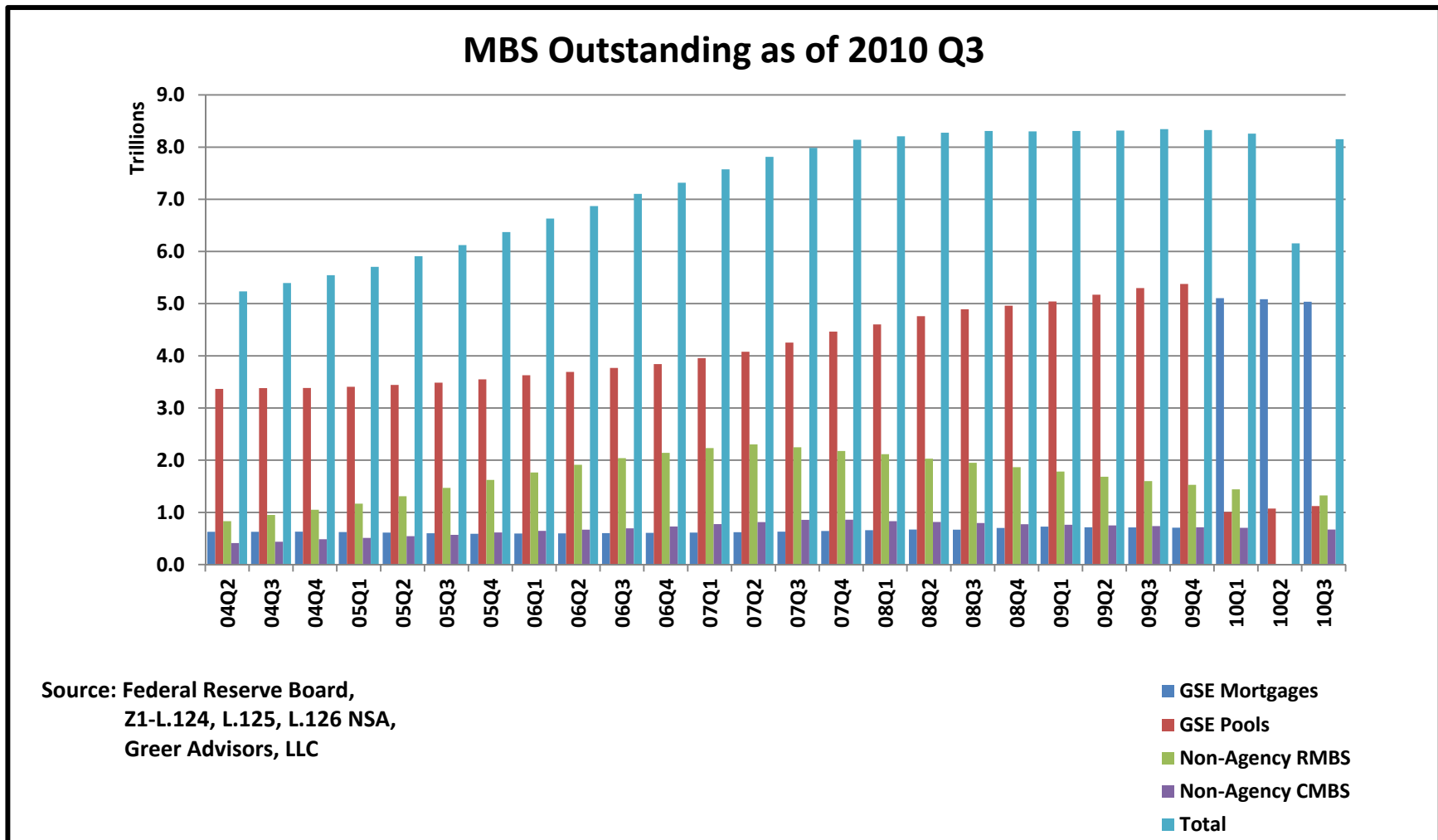
# What is a MBS?

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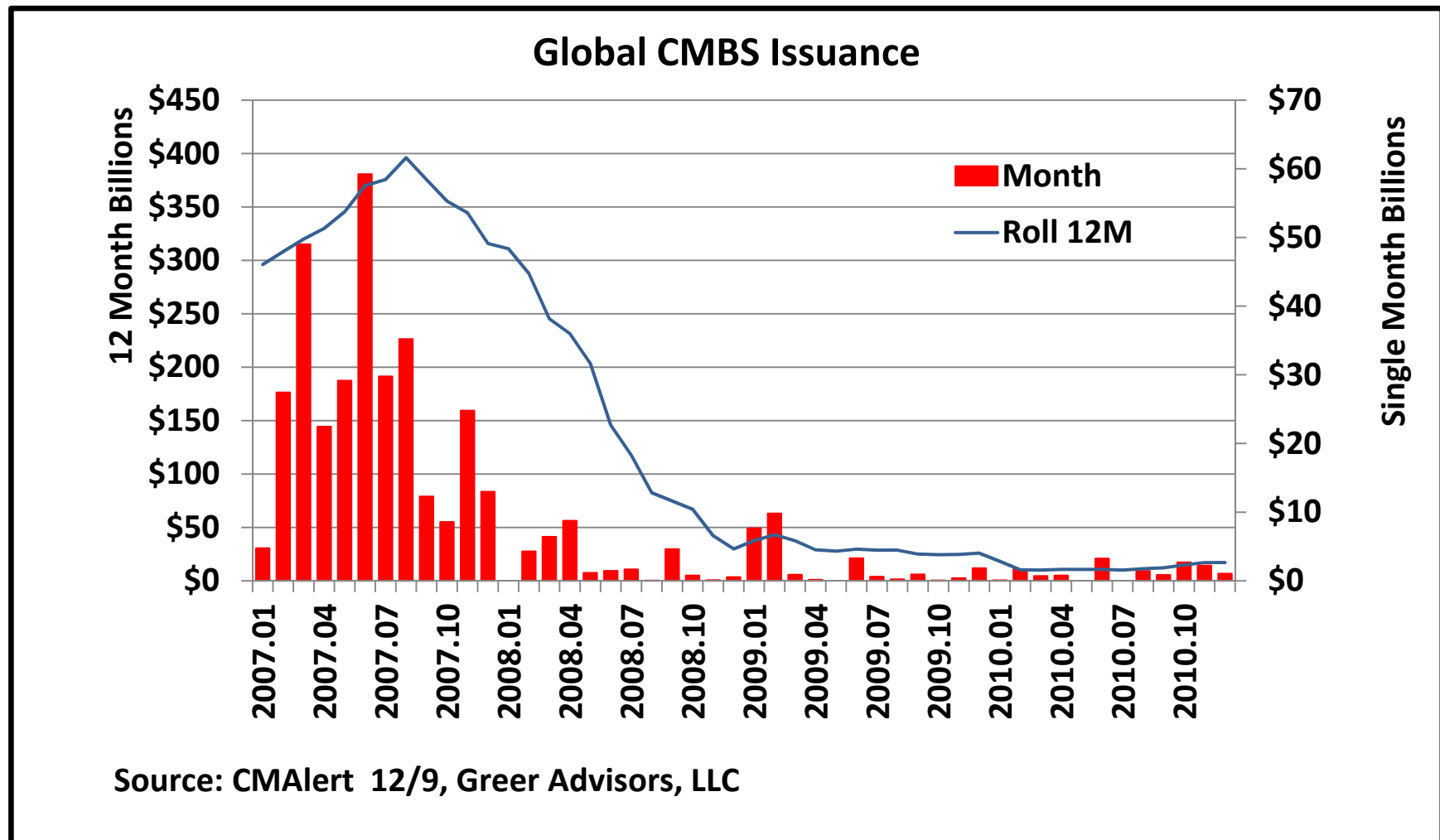
## Mortgage Backed Security

- Type of pass-through security
- Mortgages are securitized into a pool. Rights to the revenue from the mortgages are divided into many smaller pieces (tranches, strips, slices), each with differing priorities. Proceeds are distributed to investors based on the priority of their tranche.
- During 2006-2007, accounted for slightly less than 40% of all commercial real estate lending, and higher rate for residential.

# MBS Outstanding's in U.S. - Dropping



# Global CMBS Issuance





# CMBx Data

<b>Greer CMBS / CMBx Yield Rate<sup>TM</sup></b>				
<b>Tranche</b>	<b>Yield</b>	<b>Suboord</b>	<b>Weight of Debt</b>	<b>Contribution to Total</b>
<b>AAA</b>	<b>3.85%</b>	<b>29.76%</b>	<b>70.24%</b>	<b>2.70%</b>
<b>AJ</b>	<b>4.72%</b>	<b>12.70%</b>	<b>17.06%</b>	<b>0.81%</b>
<b>AA</b>	<b>6.34%</b>	<b>10.63%</b>	<b>2.07%</b>	<b>0.13%</b>
<b>A</b>	<b>10.71%</b>	<b>8.00%</b>	<b>2.63%</b>	<b>0.28%</b>
<b>BBB</b>	<b>28.31%</b>	<b>4.72%</b>	<b>3.28%</b>	<b>0.93%</b>
<b>BBB-</b>	<b>29.77%</b>	<b>3.68%</b>	<b>1.04%</b>	<b>0.31%</b>
<b>BB</b>	<b>103.48%</b>	<b>2.69%</b>	<b>0.99%</b>	<b>1.02%</b>
<b>Unrated</b>	<b>177.00%</b>	<b>0.00%</b>	<b>2.69%</b>	<b>4.76%</b>
<b>Implied Overall Debt Yield</b>			<b>100.00%</b>	<b>10.94%</b>
<b>Loan to Value Ratio</b>				<b>75.0%</b>
<b>Class-A Equity Yield   Total Yield</b>			<b>30.00%</b>	<b>15.71%</b>
<b>Class-B Equity Yield   Total Yield</b>			<b>103.00%</b>	<b>33.96%</b>

Notes: ① The table is somewhat complicated, as evidenced by the numerous footnotes. Several conclusions can be drawn. 1) If the 'Implied Overall Debt Yield' is much greater than loan rates in the marketplace, the CMBS market CAN NOT recover because the required yields are too high to make debt affordable to borrowers. 2) When the spread between AAA and BB tranches is above 500 bps (now at 9,963 bps), the market can't recover because of risk aversion for lower-rated tranches. As a point of reference, January '07 AAA-BB CMBS spreads were around 65 bps. Lastly, the yields for each tranche provide tremendous insight into the required yields for each layer in the capital stack.

② Markit<sup>TM</sup> Data and Calculations based on close of 12/15. Swap (10Yr) as of 12/14.

③ Coupon and Price data were from Markit<sup>TM</sup> for AAA Senior through BB bonds. Markit<sup>TM</sup> data was used as part of the calculations by Greer Advisors, LLC to determine Spreads. Subordination levels were from Markit<sup>TM</sup>.

④ Profit / arbitrage opportunity for the issuer was ignored.

⑤ The yield spread for "unrated" classes were based on (BBB-yield minus BB yield) times 1.0, round to the nearest bp. Class-A property equity yield was assumed equal to the BBB- (last investment-grade piece) yield rounded to the nearest 100 bp. Class-B property equity yield was assumed equal to the BB yield, rounded to 100 bps.

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# What is a CDO?

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## Collateralized Debt Obligation

- Type of pass-through security
- CDOs are securitized debt pools, similar to CMBS, but debts can be CMBS/CDO paper, car/boat/plane loans, credit cards, or virtually any type of debt obligation. Rights to the revenue from the obligations are divided into many smaller pieces (tranches, strips, slices), each with differing priorities. Proceeds are distributed to investors based on the priority of their tranche.
- Tough to gauge accurately, but most experts believe these have accounted for 5-10% of all commercial real estate lending the past few years.

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# What is CDS?

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## Credit Default Swap

- A bilateral contract where two parties agree to trade the credit risk of a third-party. A protection buyer pays a periodic fee to a protection seller in exchange for a contingent payment by the seller upon a default or failure to pay. Once triggered, the seller either takes delivery of the collateral (eg bond, note) or pays the buyer the difference between the par value and recovery value of the bond (cash settlement).
- They resemble an insurance policy, as they can be used by debt owners to hedge against credit events.
- Warren Buffet called **ED** these “Weapons of Mass Destruction”
- .....counterparty???

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# Players in “Simple” CDS

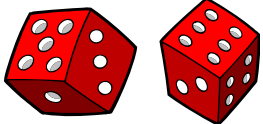
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## Business Issues Bonds

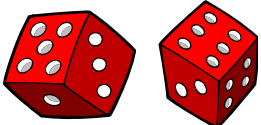


Bonds initially rated too poor for market, e.g. “BB”

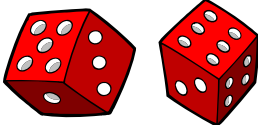
Side Bet 1



Side Bet 2



Side Bet 3

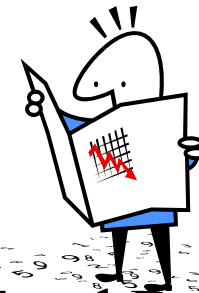


Investment Bank issues CDS (aka Credit Enhances Debt) Enough to make BB = AA, if debtor fails, IB buys bonds

## Rating Agency Rates Bonds



Gives loss forecast & amount required for “AA” rating



Pension Fund Buys Bonds with CDS enhancement  
Thinks it's AA investment

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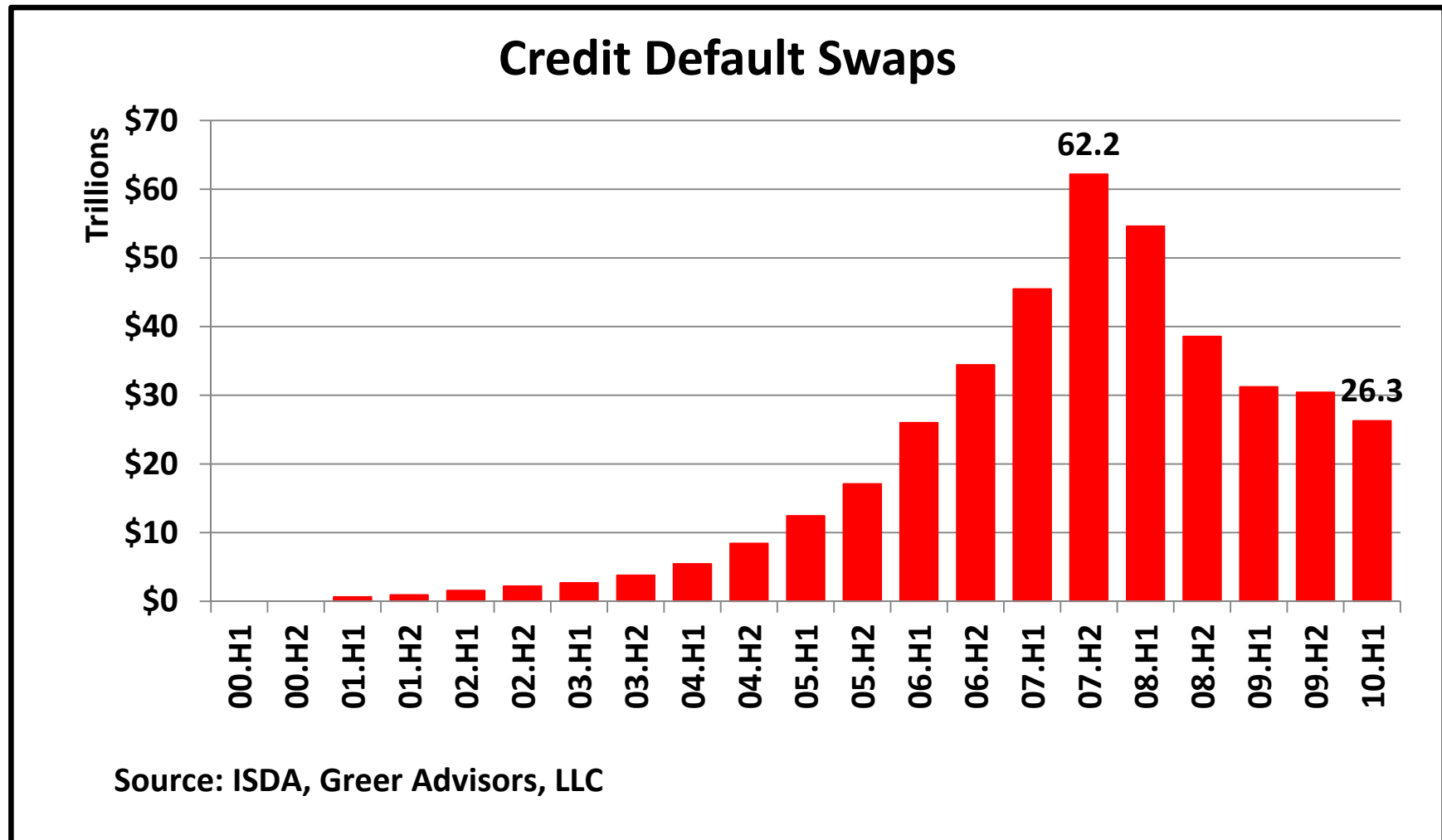
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**Greer Advisors, LLC**

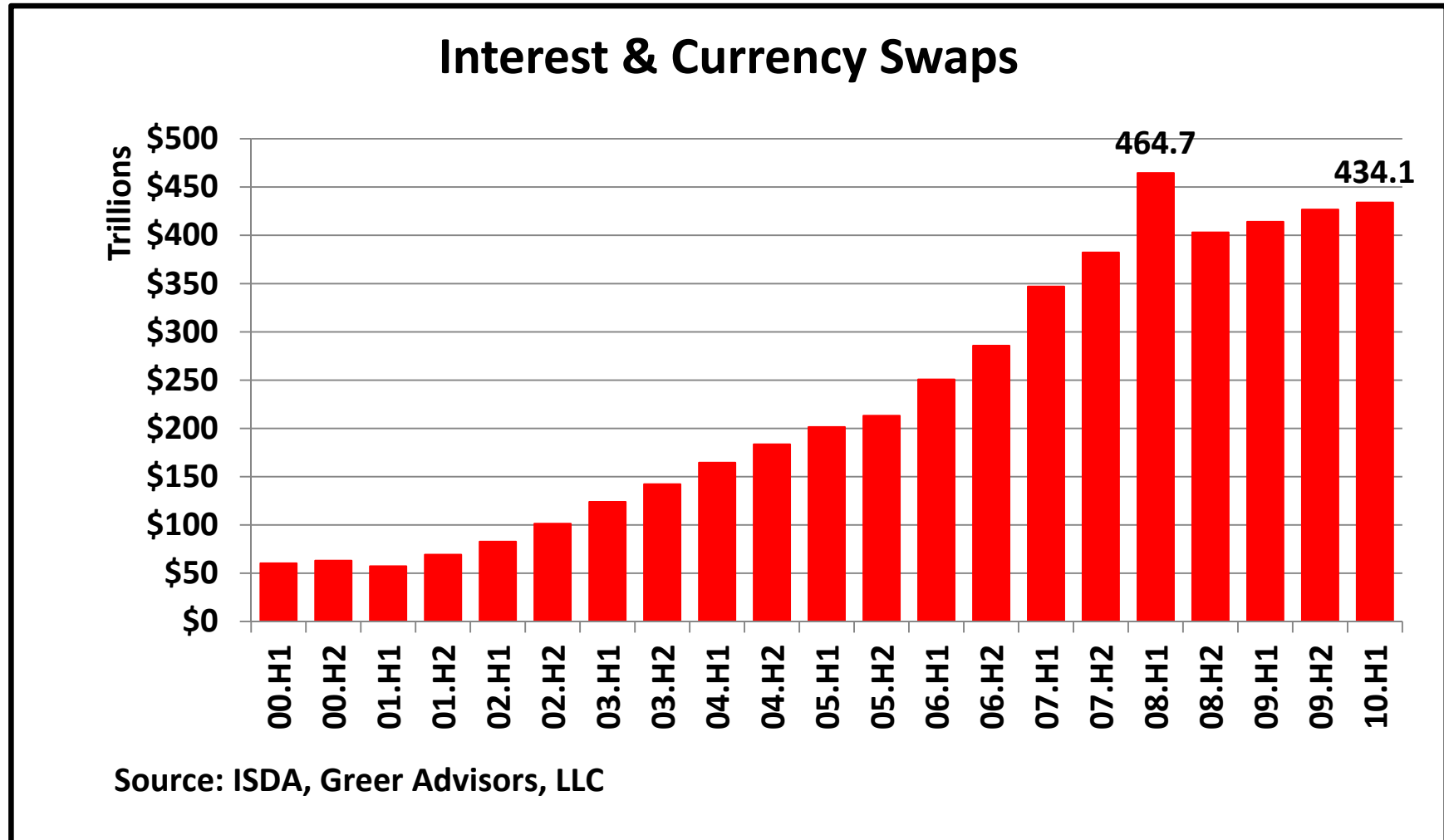
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# Credit Default Swaps



# Interest & Currency Swaps



# Top - Bottom Market Stats – as of 2010 Q3

INDUSTRIAL - 2010.Q3					OFFICE - 2010.Q3					RETAIL - 2010.Q3					APARTMENT - 2010.Q3				
Vac	Metro	Vac %	Eff Rent \$	Eff Rent % Chg	Vac	Metro	Vac %	Eff Rent \$	Eff Rent % Chg	Vac	Metro	Vac %	Eff Rent \$	Eff Rent % Chg	Vac	Metro	Vac %	Eff Rent \$	Eff Rent % Chg
1	Los Angeles	8.1%	\$6.67	3.7%	1	New York	8.7%	\$55.62	-0.6%	1	San Francisco	3.6%	\$29.92	1.0%	1	San Francisco	3.6%	\$29.92	100.0%
2	Salt Lake City	9.3%	\$4.57	-3.4%	2	Honolulu	8.8%	\$26.44	1.8%	2	Fairfield County	3.8%	\$25.20	0.4%	2	Fairfield County	3.8%	\$25.20	40.0%
3	Kansas City	10.3%	\$6.10	0.7%	3	Long Island	11.3%	\$19.82	-0.9%	3	Northern New Jer	5.6%	\$24.61	0.6%	3	Northern New Jer	5.6%	\$24.61	60.0%
4	Houston	10.5%	\$5.32	3.5%	4	Pittsburgh	11.5%	\$17.10	1.7%	4	Long Island	5.8%	\$22.66	0.8%	4	Long Island	5.8%	\$22.66	80.0%
5	San Francisco	10.5%	\$7.76	-0.6%	5	Trenton	12.0%	\$23.82	-0.6%	5	Los Angeles	6.1%	\$25.18	0.3%	5	Los Angeles	6.1%	\$25.18	30.0%
6	Long Island	10.9%	\$5.58	-1.2%	6	Stamford	12.5%	\$26.08	-0.4%	6	San Jose	6.1%	\$26.71	-0.1%	6	San Jose	6.1%	\$26.71	-10.0%
7	Portland	11.0%	\$6.25	-0.6%	7	Washington D.C.	13.1%	\$35.23	1.1%	7	Suburban Virginia	6.1%	\$24.40	0.3%	7	Suburban Virginia	6.1%	\$24.40	30.0%
8	Orange County	11.1%	\$8.54	1.8%	8	Boston	13.2%	\$27.18	-3.4%	8	Westchester	6.5%	\$32.11	-0.7%	8	Westchester	6.5%	\$32.11	-70.0%
9	Seattle	11.2%	\$9.21	5.5%	9	San Francisco	14.1%	\$21.65	-3.6%	9	Orange County	6.6%	\$26.58	0.4%	9	Orange County	6.6%	\$26.58	40.0%
10	New York	11.8%	\$5.61	-2.4%	10	Nashville	14.2%	\$19.85	-0.6%	10	Boston	6.8%	\$19.41	0.0%	10	Boston	6.8%	\$19.41	0.0%
51	Vallejo	16.2%	\$5.62	-0.7%	51	West Palm Beach	21.5%	\$20.87	-2.2%	73	Colorado Springs	14.5%	\$11.94	-0.3%	71	Colorado Springs	14.5%	\$11.94	-30.0%
52	Hartford	17.7%	\$6.39	-1.2%	52	Edison	21.6%	\$17.15	-0.9%	74	Wichita	14.6%	\$10.40	-0.4%	72	Wichita	14.6%	\$10.40	-40.0%
53	Boston	17.9%	\$5.87	-0.2%	53	San Jose	21.7%	\$25.93	-0.7%	75	Dallas	14.8%	\$14.03	0.3%	73	Dallas	14.8%	\$14.03	30.0%
54	Sacramento	18.3%	\$4.73	-4.8%	54	Jacksonville	21.9%	\$15.76	-0.9%	76	Syracuse	15.2%	\$10.60	0.2%	74	Syracuse	15.2%	\$10.60	20.0%
55	Phoenix	18.7%	\$5.03	-4.2%	55	Tampa	21.9%	\$18.83	-3.0%	77	Birmingham	15.7%	\$12.19	0.3%	75	Birmingham	15.7%	\$12.19	30.0%
56	Atlanta	18.8%	\$3.25	-7.1%	56	Dallas	22.3%	\$18.22	1.4%	78	Cincinnati	15.7%	\$12.36	-0.2%	76	Cincinnati	15.7%	\$12.36	-20.0%
57	Stamford	19.4%	\$5.95	-0.7%	57	Riverside	22.4%	\$18.57	-2.8%	79	Tulsa	15.8%	\$9.76	-0.8%	77	Tulsa	15.8%	\$9.76	-80.0%
58	Detroit	20.5%	\$3.67	-1.3%	58	Las Vegas	24.6%	\$21.07	-3.7%	80	Columbus	16.3%	\$10.70	0.2%	78	Columbus	16.3%	\$10.70	20.0%
59	Memphis	20.7%	\$2.36	-2.1%	59	Detroit	24.9%	\$15.92	-0.6%	81	Indianapolis	16.3%	\$12.33	0.0%	79	Indianapolis	16.3%	\$12.33	0.0%
60	Trenton	21.2%	\$3.92	0.8%	60	Phoenix	26.1%	\$18.73	0.1%	82	Dayton	17.0%	\$8.79	-0.1%	80	Dayton	17.0%	\$8.79	-10.0%
	<b>Average</b>	14.4%	\$5.24	-1.0%		<b>Average</b>	17.5%	\$20.77	-0.7%		<b>Average</b>	11.0%	\$32.30	0.0%		<b>Average</b>	11.0%	\$16	1.3%
1	Los Angeles	8.1%	\$6.67	3.7%	30	Los Angeles	17.2%	\$25.29	0.0%	5	Los Angeles	6.1%	\$25.18	0.3%	5	Los Angeles	6.1%	\$25.2	30.0%
8	Orange County	11.1%	\$8.54	1.8%	45	Orange County	19.8%	\$23.14	-0.5%	9	Orange County	6.6%	\$26.58	0.4%	9	Orange County	6.6%	\$26.6	40.0%
37	San Diego	15.1%	\$7.42	-3.0%	43	San Diego	18.9%	\$25.02	2.9%	14	San Diego	7.6%	\$25.26	-0.2%	14	San Diego	7.6%	\$25.3	-20.0%
NA	NA	NA	NA	NA	57	Riverside	22.4%	\$18.57	-2.8%	28	San Bernardino/R	10.0%	\$18.01	-0.3%	28	San Bernardino/R	10.0%	\$18.0	-30.0%
13	Ventura	12.3%	\$8.41	0.1%	36	Ventura	17.8%	\$18.85	-0.5%	25	Ventura County	9.7%	\$24.69	-1.3%	25	Ventura County	9.7%	\$24.7	-130.0%
	<b>Min</b>	8.1%	\$2.36	-7.3%		<b>Min</b>	8.7%	\$3.92	-5.6%		<b>Min</b>	3.6%	\$8.79	-1.3%		<b>Min</b>	3.6%	\$8.79	-130.0%
	<b>Max</b>	21.2%	\$9.21	5.5%		<b>Max</b>	26.1%	\$55.62	2.9%		<b>Max</b>	17.0%	\$753.23	1.0%		<b>Max</b>	17.0%	\$32.11	100.0%
	<b>Spread</b>	13.1%	\$6.85	12.8%		<b>Spread</b>	17.4%	\$51.70	8.5%		<b>Spread</b>	13.4%	\$744.44	2.3%		<b>Spread</b>	13.4%	\$23.32	230.0%
Source: CBRE Economic Advisors, Greer Advisors, LLC					Source: CBRE Economic Advisors, Greer Advisors, LLC					Source: REIS, Greer Advisors, LLC					Source: CBRE Economic Advisors, Greer Advisors, LLC				

# Los Angeles Office – as of 2010 Q3

<b>Market Fundamentals data as of 3Q-2010</b>						
Submarket	Inventory		Vacancy Rate		Asking Rents	
	Bldgs (#)	NRA (SF x 1000)	Current Qtr. (%)	YTD Chg (BPS)	Net (\$)	Gross (\$)
Subtotal: Beverly Hills/Century City	405	59,809	15.10	50	24.31	31.96
Subtotal: Downtown	74	33,093	16.80	240	23.35	24.66
Subtotal: San Fernando Valley	357	26,537	19.20	100	18.73	25.46
Subtotal: San Gabriel Valley	148	9,454	13.90	-70	19.28	22.53
Subtotal: South Bay	374	33,334	18.60	200	22.72	23.77
Subtotal: Tri-Cities	146	18,384	21.20	230	39.00	30.73
<b>Total: Los Angeles</b>	<b>1,504</b>	<b>180,611</b>	<b>17.20</b>	<b>130</b>	<b>23.33</b>	<b>27.70</b>
Source: CBRE Economic Advisors						



# Los Angeles Industrial– as of 2010 Q3

Market Fundamentals data as of 3Q-2010						
Submarket	Inventory		Availability Rate		Asking Rents	
	Bldgs (#)	Total (SF x 1000)	Current Qtr. (%)	YTD Chg (BPS)	Net (\$)	Gross (\$)
Subtotal: Antelope Valley	112	6,220	16.10	-170	5.68	6.61
Subtotal: Downtown LA	6,056	294,387	5.80	-70	5.92	5.23
Subtotal: Mid-Counties	2,144	104,060	11.50	-50	5.34	6.28
Subtotal: San Fernando Valley	4,010	141,581	7.50	40	7.48	8.48
Subtotal: San Gabriel Valley	3,357	163,599	9.10	40	5.41	6.52
Subtotal: Santa Clarita Valley	493	20,254	14.60	-160	5.70	6.42
Subtotal: South Bay	4,267	227,610	8.30	20	6.56	6.33
<b>Total: Los Angeles</b>	<b>20,439</b>	<b>957,711</b>	<b>8.10</b>	<b>-10</b>	<b>6.23</b>	<b>6.31</b>
Source: CBRE Economic Advisors						

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# Future - Mortgage Backed Security

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- If NSROs don't "**Get It**" Feds could replace them
- 'til MBS Returns, Real Estate markets **WILL NOT** recover
- Most banks ARE NOT in the business of holding debt
- New MBS WILL EMERGE with terms as follows
  - No "quick buck" investment banks/mortgage bankers
  - Issuer holds 1-5% of pool as "1<sup>st</sup> Loss / Good Faith" position
  - 60-80% of pool will be AAA, not 90+%
  - Buyers of paper will "re-underwrite" pools, regardless of

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# Future of Banking

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**Past Two Years have Shown largest lending decline in history - see FDIC QBP**

**CMBS and Banks Loss Rates - All Time Highs**

**Separation of “Best of Best” Class A vs. Class B/C**

**Deleverage – Expect More for Class B/C**

**More Restrictive Covenants for REITs, CMBS**

**“R” word for Loans (recourse)**

**Capital Ratios – Leverage – QE2**

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# Conclusions

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- MBS Market – Spreads are 10-100x higher than 1/07
- MBS – New Business Model will Arise
- REITs – Virtually Recovered
- Many Lenders Closed, Stopped or Reduced Lending
- Insurance Companies and Fannie/Freddie Lenders are Active
- CASH IS KING! Cap/Yield Rates Have RISEN for Class B/C
- Value Growth will Lag Rent Growth – by a Lot
- Rents / Vacancies Remain better than early 1990s
- Real Estate Cost is **NOT** the Largest Cost of Business!!!

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## Quote of the Day

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“...prediction is very difficult, especially when it’s about the future...”

~~NY Yankees #8, Yogi Berra~~

Niels Bohr

Nobel Laureate, 1922

Atomic Structure /

Quantum Mechanics



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**Greer Advisors, LLC**

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## Greer's 3-Year Forecast as of 12/15/2010

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- Forecast is a Barbell
- Margins (to 10 Yr Treasuries or LIBOR) will rise and settle at  $300 \pm 50$  bps over 10 year Treasuries, but might over-correct in the short run, say 10Yr 400+ bps.
- Rent Growth will Lag CPI growth by 2-6%.
- Values will continue to fall 0-10%/yr thru mid-2011. Individual Market Performance will vary widely. (10-30% difference in Top vs. Bottom)
- Capitalization Rates will Rise 1-3% during 2010-2012 (e.g. 5.0% to 7.25% = 30% decline in value)
- Declines: #1=Retail; #2=Office & Industrial; then Apartment
- Change Creates Opportunities – Build Businesses
- Complete Barbell Forecast

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# Greer's Recovery Signs – Prereq's to Recovery

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- CDS Exposure under \$25 Trillion (i.e. under 50% of peak)
- Stable or Decline in CMBx Yield Spreads for 6 straight weeks
- Re-emergence of CMBS market
  - New CMBS Market will include:
    - Issuer Keeps 1-5% 1<sup>st</sup>-loss piece
    - AAA Subordination near 30%....
    - AAA is 70%, not 90% of issue
- $\sqrt$  REIT Market Capitalization (Total Value) Stabilizes or Increases for 6 months
- Consumer Confidence Rises and Stays Above 70 for 6 months
  - As of 11/30/10 (last report) index at 54.1 (1985=100)
- Risk Curve (AAA Sr. vs. BB) flattens to under 500 bps. As of 12/15/10, CMBx spread stands at 9,963 bps, nearly 100%.

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# Questions / Answers

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# Greer Advisors, LLC

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