

## **Outlook for Real Estate Debt Capital Markets**

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The week ending October 10th saw the Dow Jones Industrial Average post an 18.2% decline, the largest weekly pullback for the index since its inception in 1896. Further, the Dow Jones Wilshire 5000 Index, which measures the broader stock market, is down 42% since October 2007. Make no mistake - the United States is in one of the worst bear stock markets in its history with \$8.4 trillion dollars of equity market capitalization being wiped out over the past year. With the recent bankruptcies or fire sales of several Fortune 500 financial services companies, investors are fearful that the same fate awaits other companies in all sectors of the economy and are therefore dumping stocks at an extraordinary rate. These equity market woes are the result of a credit crunch that has virtually frozen our capital markets, with banks unwilling to lend to one another, and has spread to nearly every other stock market throughout the globe, both developed and emerging markets.

While there has been much talk among the mainstream media that this collapse is the result of excesses in the residential mortgage and specifically the subprime lending markets and lack of government regulation of Fannie Mae and Freddie Mac, the reality is that the global economy has experienced a speculative bubble across all asset classes of a magnitude that has never before been seen. The practice of securitized lending through sequential-pay bond pools, which was pioneered in the 1980's and developed during the 1990's on Wall Street, is the real cause for this economic meltdown. During the post 9/11 era, bond issuers would originate or acquire an asset (a loan), not based on the risk and reward analysis that should go into any investment decision, but rather based on the fact that within a matter of a few months, these lenders could turn around and flip the asset for a profit to institutional investors in the securitized bond market. Loans were being originated at levels that had nothing to do with reality and this has had the impact of inflating asset pricing levels for all asset classes. The securitized bond market includes MBS (Mortgaged Backed Securities), ABS (Asset Backed Securities), CMBS (Commercial Mortgage Backed Securities), CLOs (Collateralized Loan Obligations) and CDOs (Collateralized Debt Obligations). The assets securitized in these bond pools include but are not limited to residential mortgages and commercial real estate loans, credit card debt, auto loans, student loans, receivables and inventory financing and royalty revenue from intellectual property such as hit singles produced by David Bowie. Any asset that generated a predictable cash flow stream could be securitized for a profit.

The rationale behind the benefit of securitized lending, as explained by the industry's proponents, is that under this structure, risk (and returns) can be more efficiently allocated to various investors according to their respective appetites for risk. This works well if the aggregate amount of risk being taken is rational. Problems arose from the fact that the rating agencies that investors relied upon to rate these bonds worked for the issuers (i.e. the lenders who were flipping these loans) and not the investors. Therefore the rating agencies' interests were not aligned with those of investors and the rating agencies were incentivized to generously rate bond pools and were heavily compensated by their clients, the issuers, who generally retained none of the risk associated with the securitized bond pools.

The US and global economies are now faced with the reality that much of the prosperity that we have enjoyed in recent history has been fictitious and based on irresponsible borrowing and now, not only will

we have to return to a consumption level based on real economic production but we will have to pay back these extraordinary debts. US consumers will feel this pain in one shape or form regardless of what actions might be taken by the Federal Government. The debts may be absorbed by the Federal Government but that will only prolong the repayment of this debt and not eliminate it. What's more, some economists think that this will not only bring about a recession but will also spur massive inflation.

Although not widely reported in the press, a large component of this asset bubble rests within the US and global commercial real estate markets. Beginning a number of years ago, CMBS lenders started to originate loans at higher leverage and lower pricing than their balance sheet lender counterparts (insurance companies and commercial banks). This was not because the CMBS lenders had a greater appreciation for the merits of investing in commercial real estate. It was simply because the CMBS lenders generally did not retain any portion of these loans because they could turn a quick profit by flipping the loan into the securitization market. This practice had the effect of artificially inflating pricing for commercial real estate by lowering cap rates. A property could be acquired at a cap rate that was very low by historical standards and still achieve positive financial leverage. This inflated trade would then be used as a comparable sale to justify an even higher priced trade the next time a similar asset came to market. This vicious cycle caused cap rates to consistently compress during the time period starting in 2000 and ending in 2007. This compression resulted in property acquisitions being underwritten at unlevered rates of return that did not adequately compensate investors for the risks they were taking. Today we are faced with a commercial real estate market where a significant percentage of its assets are encumbered by financing that cannot be refinanced in today's market. There is a large bid/ask spread between the price at which non-distressed owners are willing to sell and the price that potential buyers are willing to pay and therefore transaction volume is way down. As these CMBS loans mature, this will force sellers to the market and put downward pressure on pricing. Further potentially depressing pricing is the potential for a significant and prolonged recession that we are now facing which could have a material impact on commercial real estate fundamentals. The New York City Office Market is facing a significant increase in vacancy due to a decrease in the demand for space from financial services companies. The American consumer is likely to significantly decrease consumption due to decreases in net worth resulting from substantially lower housing prices and equity markets and this should have a material adverse impact on retail real estate throughout the country.

Although it is very difficult to predict the future, there is one thing that seems certain and that is that commercial mortgage lending will not return to the aggressive levels of recent years during our lifetime. The questions that investors are now faced with are (1) How much will prices decline? and (2) Which lenders will replace the supply of debt capital in the market. This year, life insurance companies have been active and have been able to compete much more effectively for this lending volume. However, life companies have limited capacity. Commercial banks have also picked up some of the slack however these banks are now suffering severely from the current credit crunch and therefore are limited in their ability to originate commercial mortgages. This creates a void in real estate debt capital markets that needs to be filled and the most logical category of lenders to fill this void is specialty lenders. One such specialty lender that is particularly well positioned to make a significant impact in real estate debt capital markets is Palisades Financial.

## **About Palisades Financial**

Palisades Financial (“Palisades”) is a commercial real estate lending and advisory firm that was founded in 2000 and has invested in more than \$2 billion worth of transactions, chiefly in the Northeast Corridor. The firm has created and manages PRIF® I and PRIF® II, the Palisades Regional Investment Funds. These funds consist of private equity and therefore are not regulated by the government. Furthermore, these funds are fully discretionary, flush with cash and ready to make an impact on the commercial real estate market in the Northeast corridor.

Palisades’ principals have been in the commercial real estate business as both owner/operators and lenders since the 1980’s and have lived through the last significant real estate downturn. Its professionals are well versed in the complexities entailed in financing the distressed situations that will undoubtedly arise over the years to come.

Palisades’ team of professionals have the ability to recognize and analyze investment opportunities whether debt or equity and provide a reasonable alternative to conventional lenders and equity partners. On the debt side Palisades has a long standing trusted relationship with many of the institutional lenders whereby they can utilize these valued affiliations to not only provide capital to debtors, but to also assist in negotiating an amicable refinance where both the lender and debtor walk away satisfied. Palisades understands all stages of a project from pre-development to final certificate of occupancy and ongoing operations. We do not only provide capital to a transaction but provide “Intellectual Capital” that often provides owners and developers with complementary perspectives that can enhance performance of their projects and operations.

Palisades Financial originates high-yield bridge and subordinate financings secured by a variety of property types, including office, land, industrial and multi-family properties. Borrowers have utilized Palisades's proceeds for acquisitions, development, construction and recapitalizations. Palisades invests directly in real estate and acquires under-performing mortgages, "value-added" properties and real estate-related instruments. Palisades Financial specializes in "mid-sized" transactions that are too large for individuals and too small for larger, institutional investors.