Distressed Real Estate: Chapter 2

The next (and final?) phase...

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Panel Overview

“Distressed Real Estate Chapter 2 - The next (and final?) phase...”

Now that the banks, servicers, advisors, and professionals have gone through four years of workouts what lies ahead? Which geographic regions can see light at the end of the tunnel and which ones still have danger looming ahead? This panel will explore how the world has changed over the past four years – with insight from the top minds in the real estate restructuring world. The panelists will touch on how deals get completed in this phase of the cycle and how the capital markets views certain situations and certain markets

- **Market and supply of distressed deals**
- **Valuation of collateral**
- **Specific deal examples**
- **Big assets versus loan portfolios**
State of the Market – A Tepid Recovery

- CRE prices are stabilizing with modest gains over 2012
- 5.2% YoY returns
- Approaching 2007 highs
- Treasury rates remain low and are expected to remain low for the foreseeable future
- Growth primarily found in gateway cities as domestic and foreign investors continue to look for Class-A properties with less volatile returns
- Europe remains a concern for many investors – Europe officially in a recession as of 2Q12
- Goldman Sachs characterized Eurozone policy as “incremental, reactive and inconsistent.” Sovereign debt spreads have decreases but underlying problems remain
# Economic Outlook

<table>
<thead>
<tr>
<th></th>
<th>United States</th>
<th>Eurozone</th>
<th>United Kingdom</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Real GDP Growth</strong> YoY%</td>
<td>2.3%</td>
<td>-0.4%</td>
<td>0.1%</td>
<td>2.0%</td>
</tr>
<tr>
<td><strong>Policy Rate</strong> End of Year</td>
<td>0.25%</td>
<td>0.75%</td>
<td>0.5%</td>
<td>0.1%</td>
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<tr>
<td><strong>10-Year Bond Yield</strong> End of Year</td>
<td>1.8%</td>
<td>1.3%</td>
<td>1.8%</td>
<td>0.8%</td>
</tr>
<tr>
<td><strong>Headline Inflation</strong> Average</td>
<td>1.8%</td>
<td>2.2%</td>
<td>2.7%</td>
<td>0.8%</td>
</tr>
<tr>
<td><strong>Core Inflation</strong> Average</td>
<td>1.9%</td>
<td>1.4%</td>
<td>2.6%</td>
<td>-</td>
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Data as of December 31, 2012

*2012 real GDP is based on GS GIR estimates of year-over-year growth for the full year.*

**For Eurozone bond yield, we show the German bund 10-Year.**

***For current CPI readings we show the YoY inflation rate for the most recent month available.***

Source: Investment Strategy Group, Datastream, GS GIR
Overview – The CRE Market

• Demand for CRE remains positive even as growth has slowed
• According to Reis Inc. office vacancy rate reported at 17.1 percent in Q4 2012, down only 30 basis points YoY – Q4 job growth approximately 453,000, down from 503,000 in Q3
• Asking and effective rents grew by .8 percent in Q4
• NREI expects industrial vacancy rates to decline from 10.1 percent in 4Q 2012 to 9.5 in 2013
  – Lowest vacancy rates are in Orange County, California (4.3%); Los Angeles (4.4%); and Miami (6.5%)
• NREI expects retail vacancy rates to decline from 10.8 percent in Q4 2012 to 10.6 percent in 4Q 2013
  – Lowest vacancy rates found San Francisco and Fairfield County, Connecticut (3.9%); Long Island, NY (5.1%); and Orange County, California (5.4%)
FDIC Bank Closures

- Bank closures for 2012 totaled 51 – a 45% decrease from 2011
- Helped by fewer loan delinquencies
- Smaller community banks still being affected with assets typically ranging from 100M – 1B
  - FL, Palatka - Putnam State Bank - $37.4 million dollar estimated FDIC cost.
  - GA, Marietta - Security Exchange Bank - $34.3 million dollar estimated FDIC DIF cost.
- FDIC Estimated cost significantly decreasing
- Bank failure costs are decreasing:
  - 2011 ~ 7 billion
  - 2012 ~ 2.5 billion
CMBS Delinquency Rates

- Trepp estimates the 1.73 trillion of commercial real estate debt will come due between 2012 and 2016
- CMBS delinquency rate was unchanged from November to December at 9.71% (projected to increase slightly in January 2013)
- CMBS delinquency rates appear to be stabilizing after a 6 month period of increased delinquencies
  - Trepp reporting CMBS delinquency rates in often troubled Southern Florida region dropped to 8.2% in December from 9.4% in December 2011.
- What to look for: Seven year loans issued in 2007 mature in 2014
- Maturing loans still finding it difficult to refinance (tight credit markets)
## CMBS Delinquency Rates by Property Type

<table>
<thead>
<tr>
<th>Percentage 30+ Days Delinquent by Property Type</th>
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<tbody>
<tr>
<td>Dec-12</td>
</tr>
<tr>
<td>-----------------</td>
</tr>
<tr>
<td>Industrial</td>
</tr>
<tr>
<td>Lodging</td>
</tr>
<tr>
<td>Multifamily</td>
</tr>
<tr>
<td>Office</td>
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<tr>
<td>Retail</td>
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</tbody>
</table>

Trepp December 2012 US CMBS Delinquency Report
CRE loan standards appear to be loosening but dichotomy remains between gateway cities and tertiary markets and then even further between types of loans – construction vs. Office and Multifamily, (according to Federal Reserve’s 3Q12 Senior Loan Officer Opinion Survey)

- Improved fundamentals likely an influencing factor: Commercial prices increasing, unemployment creeping lower
- Banks finding lasting solutions to distressed loans
- Between 2Q2011 and 2Q2012 78.5 percent of distress workouts were resolutions
Real Estate Loan Maturities

Source: PPR; Federal Reserve; Trepp; ACLI
Secondary Market Overview
Commercial
Single Family Residential

Presented by David Tobin
Mission Capital Advisors
Collateral Market Backdrop

Peak-to-Trough-to-Peak Valuation Cycle
/ Major-Minor Market Value Divergence

Historically Prices Drop for 2-4 years from Peak, Take 6-8 Years to Recover and Raw Land Appreciation Occurs Toward End of Recovery: Most experts agree that macro real estate price adjustments drop for between 2 and 4 years and then take 6-8 years to recover. The following chart highlights the time residential real estate markets took to fall and then return to peak prices during the most recent “savings & loan crisis”. Most notably, land appreciation will be stalled while single family REO inventory and existing horizontally built out lots are absorbed. During the current crunch, declines started at different times in different places, with Florida and Arizona leading the way, California in the middle and New York lagging but clearly “making up for lost time”. Deutsche Bank also projects similar peak-to-trough-to-peak timing with commercial real estate rents and pricing not returning to peak 2007 levels until 2017. This would imply a bottoming in 2010 and a 7 year climb back.

Moody's/Real Capital Analytics Commercial Property Price Index
- CRE markets have largely rebounded to 2006 price levels according to Moody's/Real Capital Analytics Six City Index.
- These six gateway markets are New York, Boston, DC, Chicago, Los Angeles, San Francisco.
- These markets make up approximately 46% of the overall commercial RE value.
- Debt prices in these six markets have rebounded lock step with this recovery.
- The balance of the US continues to stagnate, impacting distressed and performing loan prices dramatically.

![Chart showing historical prices drop and recovery](chart.png)

Source: Moody's
Loan Sales allow Banks and Special Servicers the opportunity to generate the best NPV for performing or distressed assets, focus on new business and better allocate special asset resources. The advantages of this process include:

- **Financing Still Challenging:** Financing markets for the sale of small commercial properties sold following foreclosure are still thin.

- **Broader Universe of Buyers:** A real estate broker may actively market a property to a select group of investors in a specific market or region but a Loan Sale accesses both local and nationally focused institutional investors with (a) a cheaper cost of funds and (b) lower yield hurdles.

- **Competitive Due Diligence Process Ensures Fixed Timeline and Minimal Retrade Risk:** REO sale standard practice is to market a property for a 30-90 day period, “pick a horse” and allow a 30-45 day due diligence period, leaving the seller susceptible to both “retrade” and financing risk. The loan sale process requires bidders to perform all due diligence in competition with multiple other bidders and close. In the current market environment having multiple investors complete final due diligence on a competitive basis, ensuring there are multiple, ready to close final bids, is essential to a successful sale on an expedited timeline. Delays caused by failed negotiated deals can materially impact assets with deteriorating collateral condition.

- **Minimal Discounts for Loans Versus REO:** Today’s sophisticated investor does not generally discount the cost to foreclose any further than a Seller’s expected cost.

- **Better Pricing/Less Property Value Decline:** According to Fitch Ratings, loan sales result in a higher net present value for the seller than many resolution strategies:
Overview of Recent & Historical Commercial Loan Sales

The 2012 loan sale market fell short of 2011 by a material measure. The following is an overview of commercial transactions as measured by CRENews.com and Mission Capital.

- Based on year-to-date sales, aggregate volume is projected to be between $20.24 billion came in at the low end of Mission Capital’s $20 billion to $25 billion 2012 projection.
- While this figure is below that of 2011, it should be noted that approximately $11.1 billion of sales emanated in 2011 from Ireland (Anglo Irish, Bank of Ireland), which would be considered a one time event.
- A dramatic increase in the number of transactions suggests a migration by banks to selling smaller-balance assets.
Securitization

An Exit Strategy or a Joint Venture?

- Low rates and a revival in bank lending are helping to revive the securitization market for credit impacted and non-performing loans.
- Nonperforming loans don’t generally qualify as mortgages under federal Remic guidelines, so a “grantor trust” structure is used instead, resulting in a single-tranche deals.
- According to Commercial Mortgage Alert, $3 billion to $4 billion of issuance could come to market based on what has traded over the past several years.
- JP Morgan actively shopping the product to investors who routinely purchase non-performing loans.
- Mission views NPL securitizations as a financing vehicle that will drive pricing because investors can re-use capital and make better leveraged returns.
- Best not to “buy into it” but rather “sell into it”: let multiple investors, using this product, compete to buy loans versus entering into a JV with only one.

### Table:

<table>
<thead>
<tr>
<th>Deal</th>
<th>Date</th>
<th>Balance (MM's)</th>
<th>UPB (MM's)</th>
<th>Advance/Upb or AAA Level</th>
<th>Purchase Price</th>
<th>Advance/Purchase Price</th>
<th>Coupon Rate</th>
<th>Properties/Loans</th>
<th>Average Proceeds Per Property/Loan (MM)</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rialto Capital, 2012-LT1</td>
<td>Apr-12</td>
<td>132</td>
<td>526</td>
<td>25.10%</td>
<td>224</td>
<td>58.93%</td>
<td>4.75%</td>
<td>320</td>
<td>0.413</td>
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<tr>
<td>Square Mile, S2 Hospitality, 2012-LT1</td>
<td>May-12</td>
<td>159.5</td>
<td>321</td>
<td>49.69%</td>
<td>243</td>
<td>65.64%</td>
<td>4.50%</td>
<td>31</td>
<td>5.145</td>
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<tr>
<td>Oaktree</td>
<td>Sep-12</td>
<td>195</td>
<td>704.6</td>
<td>27.68%</td>
<td>299.9</td>
<td>65.02%</td>
<td>4.00%</td>
<td>765</td>
<td>0.255</td>
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<tr>
<td>Waterfall, WVMT 2011-S8C2</td>
<td>Feb-11</td>
<td>69.8</td>
<td>97</td>
<td>71.96%</td>
<td>80</td>
<td>87.25%</td>
<td>5%</td>
<td>175</td>
<td>0.399</td>
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<tr>
<td>Lone Star Citi</td>
<td>Jun-11</td>
<td>362</td>
<td>362</td>
<td>60.70%</td>
<td>unknown</td>
<td>275/swaps</td>
<td>2.413</td>
<td></td>
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</tr>
</tbody>
</table>

- Single class of bonds, 0.78 year average life, JPM and Wells led deal, $350mm expected recovery (38% advance against expected recovery).
- 82% of loans are performing, 100% hospitality assets, primarily limited service hotels, projected par resolution on more than 50% of assets, Blackstone is part of the Square Mile team.
- Loans acquired from March 2011 to July 2012. 19% of the pool balance is technically performing with remainder non-performing. Pricing of bonds yielded 3.045%.
- $97mm of total certificates, private placement, 6 year average life on the 69.8mm, pool arose from performing/mall balance commercial loans purchased from Greystone Bank, purchaser initially reviewed $301mm of loans to arrive at loan list.
- Lone Star purchased two portfolios of seasoned performing loans from Citi during late 2010 and early 2011 and securitized the highest quality portion. Fixed and floating rate permanent loans originated from 2006 to 2009. Loans have some higher than usual LTV and lower than usual DSCRs. Average life of 3.4 years. AAA's priced at 275 over corresponding swaps.