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CRE Skepticism High over Fed's Plans To Buy Trillions in 'Toxic' Assets

Spending Plans Raise Concerns over Increasing Deficits, Risk of Inflation and Lack of Incentive for Sellers To Participate

Commercial real estate practitioners contacted by CoStar News expressed skepticism over announcements from the Federal Reserve Board and the U.S. Treasury in the past week over their plans to purchase or subsidize up to \$2 trillion in mortgage-related investments.

CoStar Group's Watch List Newsletter queried about 500 commercial industry executives on their initial reactions to the two plans to remove bad (toxic) or frozen loans from lenders' and investors' books in order to free up capital for them in order to lend more.

"It should help tremendously in the short run -- and then the long run? Who knows?" said Marty Cohan, a vice president in the National Retail Group of Marcus & Millichap in Los Angeles. "One would presume that what the Feds giveth, the feds shall taketh away through higher taxes or more taxes."

John Tilley, director of real estate for Jacmar Builders in Alhambra, CA, said this is the first plan from Treasury that makes any sense. But Tilley also ticked off a long list of what he thinks is wrong with federal attempts to deal with problems so far.

"We are in a deflationary economy at the moment, which doesn't seem to show any response to low interest rates or capital infusions into declining stock prices of financial institutions," Tilley said. "Further deficit spending and Keynesian economics are the easiest justifiable remedies without understanding the long-term consequences: a further weakened dollar, unsupportable national debt and large tax increases. In the end, you will see a large uptick in inflation, which will be good for the economy in the long run. However, there will still be price disparity between buyers and sellers, and the banks know this all too well at the moment."

Tilley's list summarizes the basic disagreements many in the industry have expressed with the Fed's plan: That it involves too much spending too fast and pushes up debt levels even higher, which in turn raises the specter of inflation.

Others noted that the plans do not address the sell side of the equation. Will mortgage holders be willing to sell at any price just because the government is willing to throw trillions of dollars at them?

Too Much Spending, Too Fast

In the illustration from Web designer pagetutor.com pictured with this story, the dot in the lower left hand corner represents a person standing beside 10,000 pallets each stacked with \$100 million in \$100 bills. (Note the double stacking of the pallets.)

That \$1 trillion is in addition to nearly \$12 trillion the federal government has already allocated in previous programs to boost the ailing economy, according to research by financial services analytics firm Keefe, Burette & Woods.

"If we put politics aside, which is very difficult for most people, the amount of spending by our federal government is absurd, insane, dangerous and will have an adverse effect on the economy," said Jeff Thornhill, vice president real estate technical services at First Bank Inc. in St. Louis, MO. "This is simple

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supply and demand and we are flooding the market with money and we are deflating the dollar, which will result in inflation."

"It's mind-boggling indeed," said Gabriel Silverstein, president of Angelic Real Estate in Chicago and a regular contributor to the Watch List Newsletter. But is it going to fix the problem?

"Only if the money is used to help create a viable and at least semi-liquid secondary market for loans and lending products whereby lenders can again make loans not fearful that they are forced to keep them on their balance sheets, or at least that they can do so with some reasonable certainty as to the secondary market value for those loans," Silverstein said. "Giving more money to banks hoping they will in turn lend it is like flushing more wads of toilet paper into an already blocked drain."

"The economy needs not one-time money usage (as this creates) but instead real money velocity, where every dollar turns into several dollars of activity and keeps going in circles," he added. "I believe the re-liquidization of the real estate market will only be accomplished by the creation of a renewed secondary market for commercial loan products. Without that, there will not be significant and competitive loan origination and therefore there will not be pricing transparency, without which many investors capable of being in the market are not taking an active role today."

The over-riding concern behind the excessive spending is the fear of inflation.

"With as high a debt as the U.S. will be racking up, fundamentally speaking inflation has to occur as these debt must be paid back and to do that, the government will need to print money. I haven't seen a solid argument for why inflation won't occur," said Edgar Benjamin Cabrera, an associate with Savanna in New York.

"In essence, we have already had the high rates of inflation, it just showed up in asset values and the debt bubble rather than in our currency or purchasing power," said Lane Jorgensen, investments manager with MG Properties Inc. in San Diego. "Actions in just the last two weeks to effectively monetize this past asset/debt inflation have severe risks, particularly to the American's households' quality of life. Early '80s style inflation has risen to the 50-50 probability category in my mind."

"The upside to inflation in the real economy is that all this debt in yesterday's dollars starts to become more manageable in the volume of tomorrow's dollars," Jorgensen added. "A cynical view suggests that high inflation is a mid-term intended consequence the administration is pursuing because it knows that that is a potential way to avoid the painful write-downs that otherwise need to occur."

No Sell Side Incentive

Another major sticking point with many people is that all of the incentives for spending appear in the Fed's plans appear to be on the buy side. The question they ask is: Is just giving people money to spend enough to get people to sell?

"Prior to [this week's] announcement, the very same assets were for sale but no transactions were taking place. Why? Because a market-clearing price had not been established," said Yossi Cohn, co-founder of YY Capital Partners in New York.

"There are lots of reasons why this might be the case," he continued. "One possibility is because investors did not see adequate return potential given current pricing. If this is the case, I'm not sure how leverage solves the problem. Though I think recent experience tells us leveraging up a mediocre return is, at best, alchemy that quickly can turn toxic."

"Another possibility," Yossi said, is that "market-clearing prices have not been established because the asset holder (bank) can't write down the asset further without in the same stroke rendering itself insolvent. I guess this would indicate another huge slug of taxpayer funds should be expected to prop up the selling banks subsequent to the sale of these assets."

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"How will the government as a 50% equity buyer help boost private demand?" asked Marty Busekrus, an investment sales associate with NAI - Rauch Weaver Norfleet Kurtz & Co. in Fort Lauderdale. "If a private investor has a required yield of 13%, then it doesn't matter how much equity the government is contributing. The private investor is still only going to pay for the asset at a price that yields 13%. Further, there is a ton of equity money out there. Finding equity for deals is not a problem. Finding debt for deals isn't even that big of a problem. Finding deals that make sense is the problem."

"I can't give insight from the ownership/sell side," Busekrus added, "but I do know that banks are very slow to release their loans at discounts to private buyers. This plan doesn't look like it will help get their assets moved. Investors will still offer a price that they feel is fair for the assets. Government equity or debt isn't going to change their return requirements."

"Providing extremely high-leverage (especially taxpayer dollars) on such risky transactions sounds eerily familiar to what got us in this mess to begin with," Steven D. Surgent, principal with Ardent Hotel Investors, LLC in Scottsdale, AZ. "The last thing this country needs is more debt - private or public. The 'plan' does nothing to address the pricing gap that currently exists between these institutions and investors. What additional motivation does this plan introduce on the part of the institutions to participate?"

Despite the doubts about the plans ability to re-energize the real estate markets, there was still an abiding sense in the comments that the Federal Government should not be faulted for its efforts so far.

"It is frightening to me that the first trillion dollars did absolutely nothing to the credit markets," said Jamie Gaylord, director of business development for Affinity Property Management in Portland, OR. "Where we once were being drowned with offers from banks to lend on anything from properties to corporate expansion, we now couldn't finance a Yugo. I personally do not see this as any more than a band-aid of a fix, but until someone comes up with a real solution to this mess, at least they are trying."

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Not Inclusive Enough

We think it's great that the government has come up with a plan to assist banks with public-private investment funds, instead of throwing more taxpayer money at them. But the Treasury plan would cover only \$500 billion to \$1 trillion of toxic mortgage assets. The overall problem is much larger - at least \$2 trillion - which leaves a trillion dollars worth of problems unsolved.

This plan might make sense for our investors, and us but it depends in part on the price of admission. If the minimum investment is \$1 billion, then the government is clearly looking for larger fund management companies. There are other question marks as well... What are the rules of the game? How long will the process take? Will government involvement create too much bureaucracy and bog down the process? Right now Home Equity Partners is nimble, flexible and maneuverable. Maybe we need to stay that way.

The administration's plan is designed to help banks with large toxic mortgage pools, to stabilize them by getting these toxic assets off their books and injecting them with capital. But it may not help smaller banks that are in trouble, and it certainly won't help other private owners of mortgage assets. Most of the mortgage pools we're looking at in this market are not held by banks, but by private institutional funds, investment management companies and hedge funds. These players hold a tremendous inventory of troubled mortgage assets in Southern California; the bank plan won't change that landscape.

What this plan will do is establish a price for these toxic assets, and that's what this stagnant market needs to get moving. But it also could drive up the price if the investors overpay for bank assets because they can leverage their buying power with inexpensive government loans.

Chip Larson

President

Home Equity Partners

Carlsbad, CA

Not Inclusive Enough No. 2

First, the plan favors Wall Street in that only five asset managers (namely large investment funds) will be used and they will all come from the East Coast, which is Geithner's former constituency. So the middle market investors will not be able to participate directly.

Second, this is not a plan that will move quickly. It will be a cumbersome process that will involve private and public checks and balances that

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will slow the process.

And third, the private investors could make great returns while having full downside protection. The taxpayers will have all of the downside risk, which means that unless all assets in the program perform, then taxpayers will lose.

A program similar to the RTC from the early 1990s would be much preferable because it would expose the assets and loans to a greater spectrum of investors and would work twice or three times as fast.

Doug Arnold
Principal
Baceline Investments LLC
Denver, CO
Here's To You Milton Friedman

I'm sure smart people will emerge that adjust to the hand they are dealt. If this is the approach the government stays with, the market will adjust because many of the commercial real estate assets in question have greater value in the right hands than what is ascribed to them today.

Two thoughts from Milton Friedman apply:

- 1) The government solution to a problem is usually as bad as the problem.
- 2) Only government can take perfectly good paper, cover it with perfectly good ink and make the combination worthless.

Friedman may have exaggerated to make a point, but his fundamentals are sound. Real estate, like many things, is returning to fundamentals.

Paul J. Mas
Executive Vice President
Jones Lang LaSalle
New York, NY
Assets Still Too Pricey

The massive expansion of the money supply will create inflation that will make commercial real estate even more uncomfortable.

It makes me concerned that existing loans will end up in the hands of vultures who will not act in good faith and who will be less willing to extend a loan that is paid in full up to maturity.

I would certainly look at pursuing assets under the Treasury's plan, but expect the sales price to be over the market price.

Andrew Segal
CEO
Boxer Properties
Houston, TX
Assets Still Too Pricey No. 2

The problem is the debt bubble, which burst when market participants came to understand that the level of mortgage-based debt service required was unsustainable for American household incomes, resulting in higher than expected loss forecasts on the securitized pools that then became real losses.

Two administrations have been working hard to avoid the fundamental reality, which officially emerged in the markets back in 2007, that there is just too much debt and that the only way to get the credit system moving again is for someone to take the hit (taxpayer or private banks) to write off the massive real losses on all that debt.

Debt and asset values have to be written down to a level sustained by household and business income; and, one way or another, they will be written down to that level despite what government efforts accomplish to deny and delay.

The Federal Reserve will probably be more successful [in buying up mortgage-related debt] because they can act unilaterally. While well intended, the Treasury is more likely to be surprised at how low the asset/debt values private investors will be willing to trade at and may regret the losses their new price discovery mechanism makes undeniable.

For example, if you have 85% certainty a property is headed for bankruptcy, are you going to contact the current owner/borrower and offer them a price to get them whole on their debt so they can sell or are you going to wait until you can bid on the courthouse steps?

Even if the Fed/Treasury avoids the courthouse steps, private investors will still want their payday in the upfront discount, not the back-end hope certificate based on a dubious theory. That upfront discount is not going to be palatable for banks, the Fed, or the Treasury. What is the yield-to-maturity on a CMBS pool with an 85% probability of maturity default four to eight years out?

Lane Jorgensen
Investments Manager
MG Properties, Inc.
San Diego, CA
Inmates Running the Asylum

The same crew that allowed this to occur is still in charge, and still making policy ... all of which are bailing out the culprits.

We (taxpayers) should not be buying toxic assets. They should be taken back. Has anyone ever heard of RTC? Back then, the government

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(taxpayers) did not buy them, they were seized/inherited from defunct companies/banks. It should apply here.

Why? Because it discourages excessive risk taking and punishes only those who make (major) mistakes, as it should be. By the way, at the end of the day, RTC made money, as compared to having a \$64 trillion dollar debt to repay.

If we bailout/buy these assets/bad companies, we sow the seeds for the next disaster. People will have no respect for risk, experience, effort, energy, and brain cells. They are already joking that "I need/deserve to get a bailout!" Amazing.

Commercial real estate will recover (slowly), but will be better for this in a year or two. Following the 1990's debacle, many learned some very hard lessons, which they did not repeat (generally) this time around. This problem was primarily residential and credit driven, versus commercial real estate driven.

Dennis Duffy, MAI
Principal/CEO
RCDH & Co.
Washington, DC
Too Excessive Leverage

This bailout seems to be haphazard and spiraling. As far as the most recent announcement about the asset purchase participation program, I have serious doubts. If the goal is to bring private equity into the mix in order to buy up the assets and bail out troubled lenders, why then are we (and I do mean we) requiring as little as 5-6% equity from the investors? Is it not excessive leverage that produced the coming sea of defaults in CRE and that has already destroyed the residential market?

I do represent lenders in the sale of distressed "For Sale" residential developments and commercial properties. Loose underwriting and ill-conceived projects are a major part of the overall problem and this problem is compounded by many lenders' inability to separate the loan amount from today's actual value.

Brecht Palombo
Broker, Auctioneer
Tranzon Auction Properties
Lexington, MA
What's Plan B?

I am very nervous about this plan. I feel that this administration is moving too fast on too many issues at the same time. I have no problem paying my fair share, but I want to know about the plan ahead of time. The fact that this administration rolled out a 1,000+ page plan that nobody had any time to even read, let alone discuss rationally scares me. We are about to spend more money on a single problem than any other group of people in history. I don't feel that anybody, the President included, knows or understands enough about this problem to move ahead so fast. This is all assuming that this one single infusion of money will fix not only our economy, but also the world economy in general. I guess my question is..."What is Plan B? What do we do if this doesn't work? Where will the next \$2 trillion come from?"

The President himself said that this plan wasn't perfect, but it was needed. When we see what a debacle AIG turned into, are we ready to blindly trust him with this next adventure?

Michael DiBona
Account Manager
Comsys
Waltham, MA
Give Me the Ol' RTC

I think it's a challenging plan. From how I read it, banks will have to have to sell either directly to the government, or via an auction process, these bad loans. The government will turn around and sell the loans to public entities, providing both financing and a risk guarantee, to end buyers.

So let's say Bank of America takes a \$10 million loan (par), to the government. What is the price the government is willing to pay? If they pay par, they've over paid. If the government pays \$5 million (the real value), Bank of America could just as easily sell it to an investor directly. And if there's a bidding process whereby the government auctions the loan and provides financing to the Blackrocks of the world (which is what I think they're going to do), Bank of America is still going to lose \$4 million or \$5 million on this loan.

My point is that somehow, the asset needs to leave Bank of America's balance sheet and it's going to do so at a loss. Is it going to be less of a loss via a bidding process or via the government financing the acquisition? Maybe, but for most institutions that don't have \$1 trillion of deposits, these multi-million dollar losses (whether it's \$3 million or \$5 million on an average loan), will still kill the banks.

The real solution is another RTC. It's that simple. The RTC/FDIC can seize the problem banks, sell off the bad loans, with financing, and we'll move on. But until that happens, and I believe it eventually will, this problem is just going to be prolonged. The fear on behalf of all the institutional investors relative to the rules being changed with this new program, coupled with an inability for banks for sell these assets and take actual loss makes me think the government is still not getting the solution.

Tony O'Neill
Broker
Voit Commercial Brokerage
San Diego, CA
First to the Trough

The larger investment houses and hedge funds will be first at the trough. They will benefit from the leverage and nonrecourse financing provided by the government. At the end of the day, someone will have to own and run these investments. Hopefully private investment will be able to still

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get involved by buying the assets from the larger guys at prices that reflect current value. With proper stewardship over the long term, the private investors will add value and should benefit.

Joseph Jannetty
President
Janco Development, LLC
Plymouth, MA
Buy Bricks & Sticks

The first thing that comes to mind is: Inflation is coming ... Fast! So buy gold or real estate or both. I think the Treasury plan will increase overall sales volume for investment property once inflation ticks up. Cash may be king but keep it in the bank when you have double-digit inflation and you're going to see your wealth evaporate. A few of my investors will buy mortgage debt but most will stick to what they know and what they have been buying for years - income producing property.

Chad P. Tiedeman
Broker
Phoenix Commercial Advisors
Phoenix, AZ

Why the Taxpayers?

Did the federal government ever fix anything by throwing money at it? Why is it a good idea for taxpayers to buy toxic assets? Let the marketplace sort out the losers and winners.

Charles Park
Credit Analyst
Avidia Bank
Worcester, MA

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