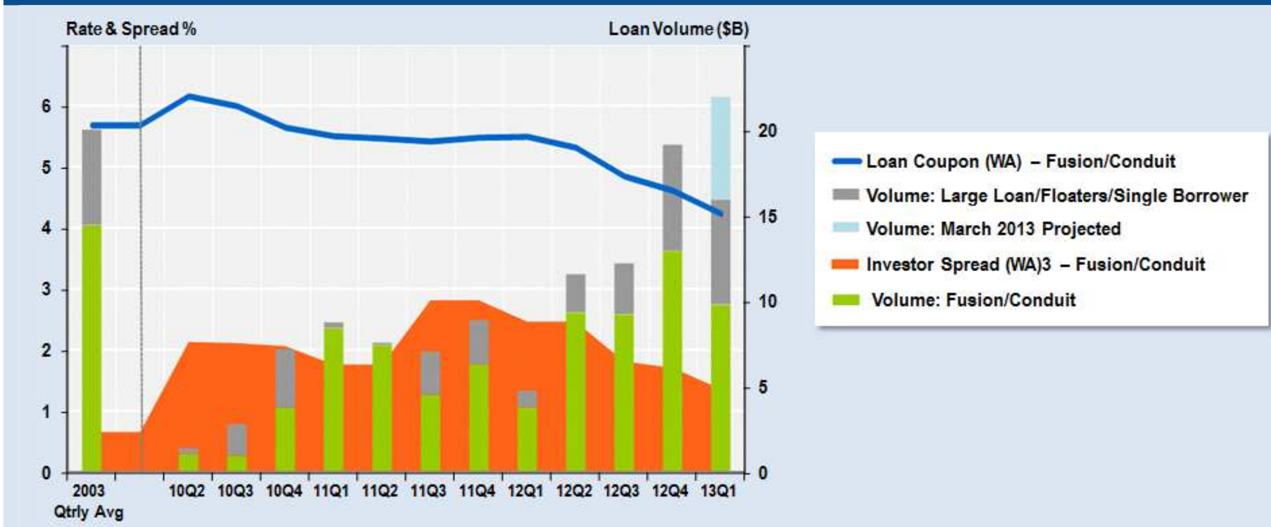
PCCP Market Commentary
Leverage is Back
Second Quarter 2013

The 2008 financial crisis may forever be associated with one word: leverage. Homeowners (no money down mortgages), investment banks (30 to 1 leverage) and governments ($1 trillion deficits) took on too much debt, and the resulting correction has been painful.

Now, it seems that leverage is returning to commercial real estate, presenting new opportunities and a new set of risks. Leverage has grown more complex, and before making an investment, investors need to consider how leverage will impact investments in different parts of the cycle. Skillful management of leverage will be critical for investors to achieve required returns and survive any potential market correction.

The increasing volume, and relaxing underwriting, of CMBS may be the biggest story in real estate capital markets this year. The first quarter saw $23 billion of new issuance, up almost fourfold from a year earlier. Estimates for 2013 are being adjusted upward from $65 billion to $70, or even $90 billion.[1] Investors are accepting lower coupons even though credit quality seems to be slipping. The chart below shows coupons and spreads declining over 100 basis points from a year ago even though treasury rates were flat. Kroll's rating of the latest CMBS issuance shows a weighted average LTV of 98.8% and over 42% of the loans are above 100% LTV.[2]

U.S. NEW – ISSUE CMBS TRENDS AS OF MARCH 3, 2013



Sources: Commercial Mortgage Alert, PPR

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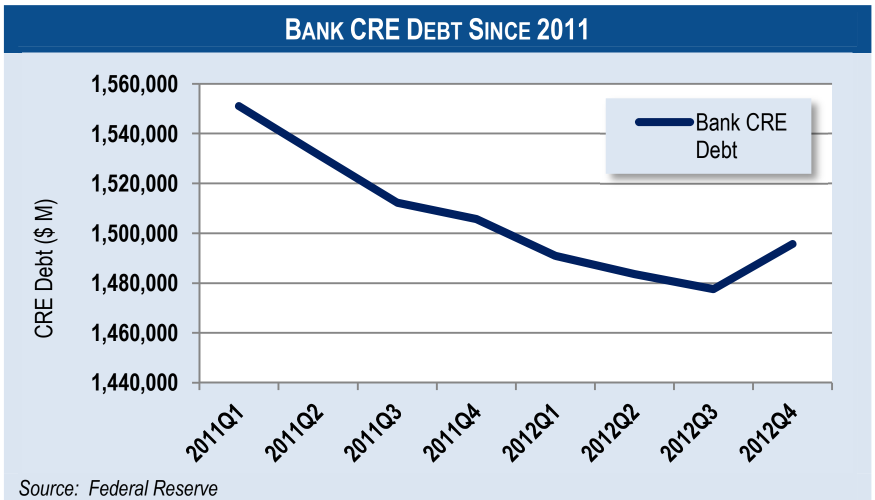
[1] *Commercial Mortgage Alert April 5, 2013 and PPR Client Update March 11, 2013*
[2] *CoStar Advisor Newsletter April 10, 2013. Kroll rating for MSBAM 2013-C9*

As we discussed in our First Quarter 2013 Market Commentary, banks are investing in earning assets, which in our world means making new loans on commercial real estate. The biggest banks still have substantial troubled loan portfolios, but we are seeing an increased emphasis on new business. In our previous letter, we identified the "Haves" as the best customers, with strong balance sheets, and trophy real estate collateral. The banks are focused on these customers. The chart below shows total bank CRE debt outstanding made a definite upswing at the end of 2012, and based on our observations this trend is continuing in 2013.



In our business, the more interesting aspect of the return of leverage is the availability of debt for more exotic transactions like loans on loans, purchases of A or B notes, or financing at the fund level. The securitization market has seen the return of deals backed by troubled loans, transitional loans, and other similar collateral. Debt funds are also increasing leverage as they try to offer competitive rates to borrowers while achieving absolute return hurdles that are set by the real estate private equity market. *Q: How can you make money at a 7% preferred return when your business is making loans at 6%? A: Leverage.* But great care must be taken when evaluating leverage on financial instruments. Memories can be short in this business. Loans on real estate generally have fixed terms and very few covenants. Loans on financial instruments do not operate that way at all, and in certain cases, may be called much earlier than the maturity of the underlying loan. Leverage on loans is for professional use only. Successful real estate debt providers must be as skillful in levering their programs as they are in creating the loans in the first place. Successful investors will realize this and will spend as much time understanding program leverage as they do understanding how their debt managers see flow and create value.

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