



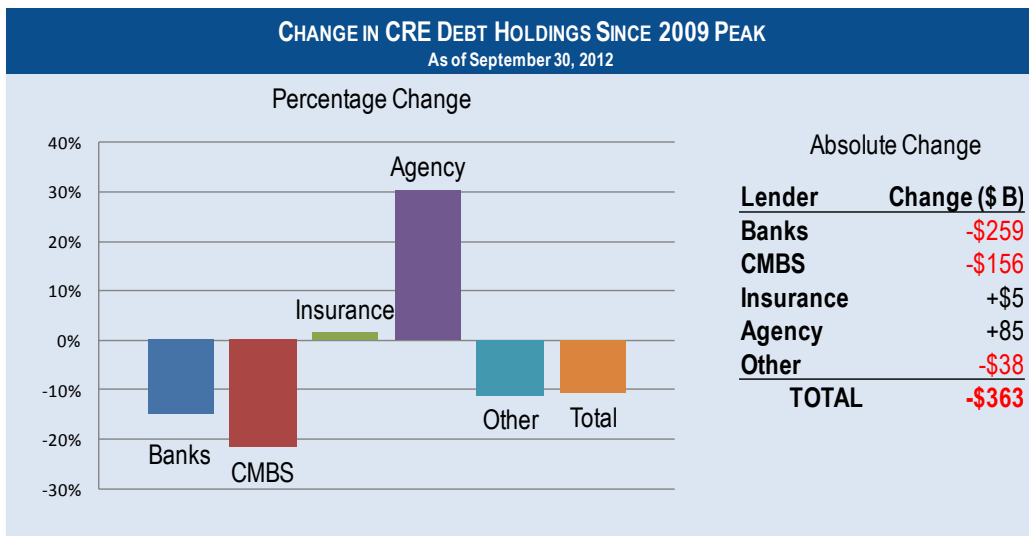
PCCP Market Commentary

“Haves” and “Have Nots”: Anecdotes vs. Stats

First Quarter 2013

As we enter 2013, we are more than four years into the Global Financial Crisis. As stated in prior commentaries, PCCP believes we are only 40% of the way through the real estate workout cycle. Our view is consistent with the most prominent recent academic literature, which argues that leverage-induced recessions run 7-9 years (*This Time is Different* by Reinhart and Rogoff). Anecdotally, it feels like strong financial institutions are starting to invest in earning assets, which in our world means making new loans on commercial real estate (“CRE”). Real estate was hit especially hard and the recovery has been a story of “haves” and “have nots” as we all know. The “haves” are the best customers, with strong balance sheets and trophy real estate, or anyone with a Class A apartment project. The “have nots” are everyone else. But what do the numbers show? We analyzed data on the CRE debt world as a whole and the three largest banks holding CRE debt to see how our anecdotal observations match up against the statistics. We conclude that although CRE lending is showing signs of life for the “haves,” there will still be plenty of opportunity to lend on and invest in the “have nots,” specifically institutional-quality, non-core asset recapitalizations.

Recent lending trends have finally had enough time to show up in the aggregate data. As seen below, the total CRE debt outstanding has declined as expected but the losses have not been equal across the board. The total lending market shrank 11% but banks (-15%) and CMBS (-22%) had outsized declines. Banks are almost half of the US market, so their withdrawal had serious effects. Much of the trophy CMBS business went to insurance companies, and a large portion of multifamily lending went to agencies, up a whopping 30% (multifamily representing a significant portion of the “haves”).

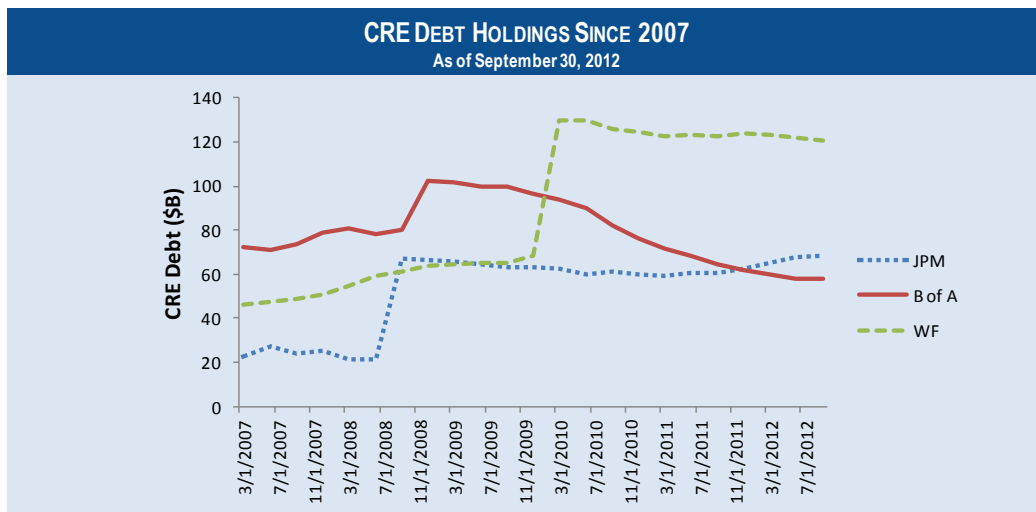


Source: Federal Reserve Board

Transitional and Class B assets are much more interesting as the recession created more of them, but traditional sources of capital for these assets (CMBS, banks, and “other”) have seen the biggest declines. CMBS has been relatively quiet and lost major market share while banks have focused on lending to the “haves.”

Therefore the capital void for transitional assets could be filled in one of two ways. The first channel is increased lending from the “Other” category (debt funds, mortgage REITs, etc.) but the data shows this group shrank 11% (See PCCP’s January 2012 commentary “Where are All the Specialty Lenders?”). The second source is simply equity deleveraging. These assets now require more equity capital than during the boom years, due to lower overall leverage and tough debt terms on the “have nots.” Even with rescue equity, the “Other” debt category is failing to increase supply even though demand is surging. This data validates our market observations that the “haves” can easily get capital from insurance companies, agencies, and banks while B assets see little capital as CMBS and “Other” lenders have pulled back and banks stay away from transitional assets.

We dove deeper by examining the CRE lending trends at Wells Fargo, Bank of America, and JP Morgan, the three largest bank holders of CRE debt. Each bank saw debt portfolios spike from financial crisis acquisitions (Wachovia, Washington Mutual, Merrill Lynch) but their responses have been different. Wells Fargo is the market leader but has been holding steady over the past several years. Bank of America has almost cut its portfolio in half, although this trend appears to have leveled off in recent quarters. JP Morgan has shown the greatest recent growth and is above its 2008 peak. Anecdotally, we know that these banks are concentrating their efforts on their best customers— the “haves” who need the money the least.



Source: FDIC

The data from the industry, large banks, and observations in the market lead us to important conclusions. CRE debt capital is still scarce and the “have nots” will continue to struggle to secure debt at today’s record low interest rates. This provides opportunities for specialty lenders willing to finance institutional-quality transitional assets. Equity capital will also be in greater demand as the “Other” debt category fails to keep up with borrowers’ needs. As bank CRE portfolios stabilize and begin to grow with new performing assets, banks will dispose of their non-earning assets. This creates opportunities for DPOs, note acquisitions, REO purchases, and other strategic investments with potential to add value and realize strong risk-adjusted returns.

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