01.29.08

Over the last several weeks I've noticed two oft-cited references which triggered this somewhat rambling memo.

The first is: "The most expensive four words in the English language are – ITS DIFFERENT THIS TIME". I have seen it attributed to at least 4 different people, but I am sure they would all like to take credit for it as its so insightful -- and so current. I must admit – until just a few months ago -- I found myself using that very phrase in rationalizing the bids I was making on office buildings. (Bids I am now glad I didn't win.)

The second is "The Minsky Moment", named after a (now deceased) economist, which refers to the moment a market moves from an "investment market" to a "speculative market". You can find more on Minsky at www.newyorker.com. My Minsky Moment was last Fall when a friend and highly respected investor told me – in explaining his very aggressive bid and his 5 day due diligence period on a $100 million plus deal – "due diligence is for sissies". Or maybe it was even earlier last year when a waiter in a nice Miami restaurant told me about the 2 - $1 million condos he was buying and that his plan was to flip one and take the profits to pay down the loan on the other. I wonder how many shifts he is working today.

Actually there is a third one – this time attributed to Warren Buffett: "You find out who wasn't wearing a bathing suit when the tide goes out".

So far, Commercial Real Estate ("CRE") has been able to avoid the more dramatic events in the financial markets. People can still be heard saying: "It really is different this time." But I am not so sure CRE will be so fortunate going forward. The sizable drop in REIT prices would seem to me to be a precursor to a similar sized drop in CRE values across the board.

The incredible volatility in the capital markets has to eventually negatively impact the availability & cost of both equity and debt capital in our world. Any loan to any borrower becomes "subprime" when there is too much debt and too little cash flow to support it. Pain is not going to be limited to the housing sector – it is just "the canary in the coal mine". Or should I say, "The Black Swan", the unforeseen event with dramatic consequences outlined in Taleb's new – and amazingly prescient – book. The commercial real estate debt markets have obviously been impacted already, but the love

affair of institutional investors and their managers with CRE as an asset class may soon be cooling. Its difficult for me to believe that the combination of slowing rental growth + slowing absorption + higher cap rates + more expensive, lower LTV debt won't eventually lead to substantial write downs on institutional portfolios -- particularly on assets bought or appraised in the last 24 or so months. (Just wait until the large institutional owners/lenders on large land holdings start to value their investments.) If that does occur, institutional investors may well become far less enamored of US CRE. Allocations to US real estate will be frozen or reduced and what is left will likely go towards off-shore investing. (The old "how do you keep them down on the farm once they've seen Paree – or Mumbai -- issue. More on that in a few years).

Additionally, the capital markets which have driven CRE appetites and thus values are bound to go thru dramatic changes. As each day goes by all of us read about the "opaqueness" of this new generation of financial structures. When investors can't understand what they are investing in, they should – and will begin to – avoid it. As Sir John Gleve, a deputy governor of the Bank of England recently said: "Sophisticated opaque bespoke products may not survive...people are going to want products built up of units they understand". Sounds pretty sensible to me, but we've seen that the very architects of these instruments unable to explain what is really in them and what they are worth - thus the incredible write downs at the major Wall Street houses and beyond. These legitimate fears will only be exacerbated by the periodic jolts such as the Societe Generale debacle. AND SG was ironically hailed by the French as the model for creative financing world wide! (As one wag put it: this is what happens when someone exceeds the mandated 35 hour work week!). As George Soros said at Davos, "The super-boom got out of hand when the new products became so complicated that the authorities could no longer calculate the risks and started to rely on the risk management methods of the banks themselves". And those methods were flawed.

The question we all need to start thinking about is, If these exotic instruments (CMBS, CDOs, etc) which drove our debt capital lose favor, what will replace them and at what volume & cost?

So what do we do? Steve Felix recently gave some excellent advice in his blog that it was probably time for senior execs to hop on a plane and visit their clients. They are bound to be having the same concerns and will be looking to their advisors for answers and guidance. Our industry usually has an annual buzzword. (Who can ever forget "new paradigm" or "four quadrants") I think in 2008 its going to be "risk management" -- a phrase not often heard -- nor contemplated -- in the real estate

business. I would suggest that the concept of "risk management " in our entrepreneurial industry is too often equated to "being negative" -- especially in a hot market.   And being a "risk manager" – if there even is such a position -- has not been the path to stardom. You should be ready to discuss what your risk management processes and procedures really are -- and how you are utilizing them in this changing market. My first, easy suggestion is that when you do "upside " and "downside" runs on an investment, make them realistic. Too often the "upside" is a 13 % IRR and the "downside" is an 11. The markets are far more volatile than that. In addition begin thinking about and articulating your strategies going forward into a likely difficult environment. Those strategies are sure to be different, possibly dramatically, than the ones you pursued over the past 5 or so years.

AND...Oh yeh - make sure when you go you have your bathing suit on!