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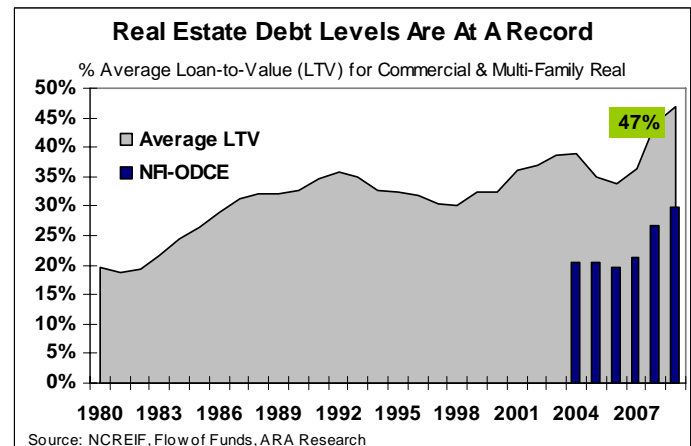
The Trillion Dollar Wave of Debt: Opportunity to Capture Returns or Run and Hide?

July 2009

Despite the staggering numbers reported daily on the amount of real estate leverage in the economy, few can truly grasp the impact that the “trillion dollar wave” of debt maturing over the next few years will have. Real estate debt is at record levels relative to its long-run averages. For investors, this level of debt, combined with the wave of maturities, is the 800-pound gorilla — destroying some investors’ equity while, at the same time, offering investment opportunities for core and value-added investors that have not been seen in almost two decades.

Real Estate Needs to Raise \$700 Billion in Equity

One of the themes of this recession has been a systematic and painful deleveraging of the global economy. While commercial real estate has yet to experience the full extent of this, investors are feeling the pain of value declines and more restrictive lending. According to the Federal Reserve, commercial real estate values have declined by over 18% since the market peak, pushing overall loan-to-value (LTV) ratios to a staggering 47%, compared to a long-term average of 32%. The more significant issue, however, is the disappearing act that owner equity is experiencing, as values on levered real estate drop. Many CMBS loans created at the market peak in 2007 are now approaching 100% LTV levels and equity investors in these deals are finding themselves with nothing left on the table.



Possible US Commercial & Multi-Family Deleveraging Property				
Trillions \$	Value	Debt	LTV	Equity
Peak	\$9.1	\$3.3	36%	\$5.8
1Q2009	\$7.4	\$3.5	47%	\$3.9
Return To Long-Run	\$6.7	\$2.1	32%	\$4.6
Possible Additional Change	-9.5%	-38.7%	-15.0%	16.8%

Source: Flow of Funds, ARA Research

What will it take to deleverage real estate back to its long-term average for debt to equity ratios? We estimate that real estate will need an equity capital infusion of over \$700 billion. To put the enormity of this capital need in perspective, \$700 billion of new capital is roughly two times higher than the total level of real estate transactions competed in 2007 when real estate transactions last peaked. Due to the size of this need and growing return requirements that the entire capital market system is now demanding, the likelihood of achieving above-average



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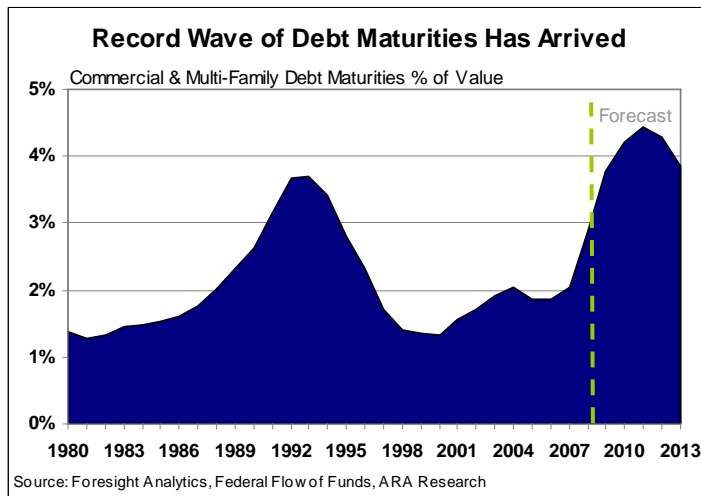
returns in the next investment cycle is high. In short, while many existing investors are being crushed, for new investors the opportunities are enormous, as those with ready capital are able to demand some of the highest returns in recent history.

Record Trillion Dollars in Loan Maturities

The real estate sector will experience a record wave of loan maturities from 2010 to 2013, as 17% of outstanding real estate loans are coming due, double the “normal” volume. This means highly leveraged borrowers are faced with the unpalatable choice of:

- Obtaining more equity
- Securing a short-term loan extension
- Executing a forced sale
- Relinquishing the property to the lender altogether

On an inflation-adjusted dollar basis, this wave of mortgage maturities is 70% above the early 1990’s level, at just over one trillion dollars.

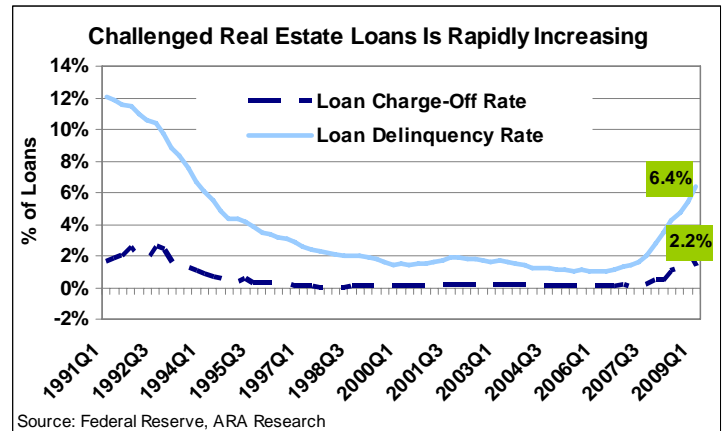


Many lenders will want to remove challenged assets from their books and are likely to offer to sell loans maturing over the next few years at deeply discounted values relative to par. So far in 2009, FDIC and CMBS lenders have sold loans at an average of only 46% of par. While perhaps only the worst of the worst has already been liquidated, clear opportunities to acquire distressed debt and equity on good quality properties are likely to appear during this period. One must note though that investments with exceptional returns bring exceptional risks — investors need to be extremely cautious in their due diligence and in

selecting markets. In this wave, there is as much chance to ride the crest on these investments as there is wiping out.

Loan Defaults/Foreclosures

Reflecting the declines in property values, the level of commercial real estate loan charge-offs and defaults continues to rise. In particular, loan defaults are up more than 420 basis points over their levels during most of the 2000’s. More telling, however, is the level of loan charge-offs due to cratering property prices in many markets where the likelihood of recovery has sunk to zero. We expect at least a doubling of the current loan charge-off rate over the next two years, suggesting that this process is only in its initial stages.

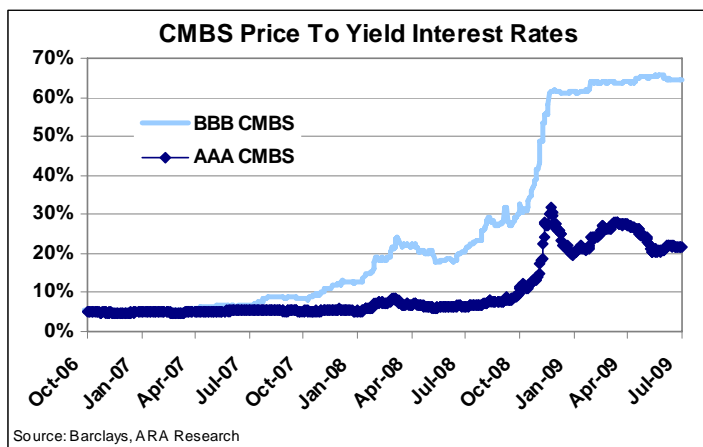


Similarly, a record 5.4% of CMBS loans are now in special servicing, as master servicers transfer loans to special servicers when signs of trouble emerge. The increase in this metric is noteworthy as it indicates that an increasing number of CMBS loans are likely to face liquidation. Given the structure of CMBS securitizations, with various tranche holders having different motivations and rights, these workouts/liquidations will not be easy and will take some time to resolve.

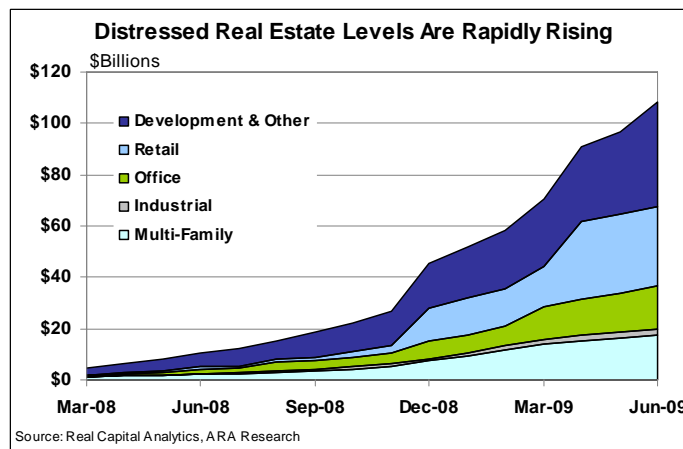
In total, the special servicing rate has now climbed for 14 consecutive months and is 13 times higher than the record low of 0.40% in August 2007. The bulk of this increase has come since the end of 2008, when the rate was a mere 1.62%. Newsworthy defaults such as that by General Growth Properties (GGP) have contributed to this sharp increase, and there is little reason to doubt that more are on the U.S. horizon.

CMBS is Pricing in Losses

For many CMBS pools, the expectation of a high loan charge-off rate is now factored into the pricing, with existing BBB CMBS currently priced to yield over a 60% rate of return and AAA CMBS priced for over a 20% yield, suggesting that investors are factoring in a fairly high risk premium.



oriented real estate, with a potential for more to come across the asset class.



Rising Levels of Distressed Real Estate

From industrial properties in Los Angeles to shopping centers in Las Vegas and high priced CBD office buildings in Manhattan, the volume of properties with distressed owners across the U.S. has grown to over \$108 billion. Fed by GGP’s bankruptcy, retail is leading all sectors with \$31 billion worth of properties in distress. GGP’s fall has added to the existing condo and casino trouble, making Las Vegas the poster child for real estate under pressure, followed closely by Manhattan, with stress in both office and multi-family assets, (although given the huge size of the New York market, on a percentage basis, the level is below the national average). Similarly plagued are the Southeast, Arizona and California, as weakness in these local economies has been more significant than in other areas. To date, only 23% or \$25 billion of so-called properties in distress have been able to resolve their problems, although most of these have been short-term solutions and true corrections have not been completed in most cases. In particular, development properties, with a high concentration of equity tied up in land values, have experienced some of the largest market stress, as land has declined at a greater rate than real estate in general. With multi-family asset values also under pressure, it appears that most of the distress has been focused on consumer

Changing Debt Standards

How have lenders dealt with this phenomenon? In a survey of senior loan officers by the Federal Reserve Bank, the data shows that since mid-2008, over 70% of the lenders surveyed are reporting tightening of credit standards.

These changes have included:

- Reduction in loan-to-value ratio by at least 10% to the 60% to 65% range.
- Elimination of non-recourse lending or even a further reduction in LTV to get a non-recourse loan.
- Increases in debt service coverage ratios, often requiring 1.5 times vs. 1.1 to 1.3 times previously.
- Limited loan sizes to \$50 million, which has in effect made it very difficult to sell larger properties, as the loan approval process from putting together lenders can be difficult.
- Increased interest rate to reflect risk.

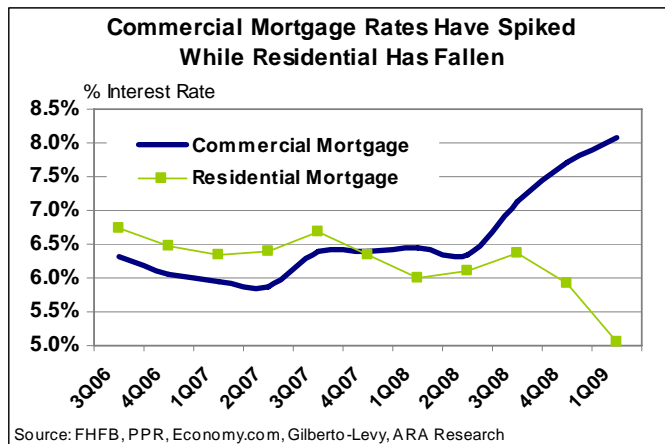
Thus, credit is much harder to attain and that which can be comes with much more onerous terms. The impact on existing owners (and those looking to buy with credit) is obvious.

Commercial Rates Spike

Reflecting increased risk and a lack of government pricing support, commercial mortgage rates have spiked to the 8% range vs. 5% range for residential mortgages. With this run up in rates, senior real estate lenders now have

opportunities to realize the most attractive potential returns in years.

With limited debt sources, the volume of transactions has now slowed to just 6% of the volume seen at the market peak. The CMBS market, which represented half of the loan volume, has essentially dried up and has, for the most part, been replaced with assumed debt and seller/private financing. Despite this shift, with the trillion dollar wave oncoming, other sources of debt will eventually be needed to soak up loan maturities in record numbers and private short-term lenders will need a source for long-term take-out financing.



Conclusion

Without a doubt, the numbers investors are facing are staggering:

- A trillion dollar wave of debt maturities
- The need to raise \$700 billion in equity
- A fundamental shift in financing sources and an unwelcome spike in mortgage rates

However, from this distress, significant opportunities will present themselves for those who are prepared to deploy both equity and debt capital judiciously. American sees an eventual liquidation and refinancing of most distressed owners that will set market pricing for new investments and lead to increased transaction volumes. While this is likely to start first with the sale of discounted debt, in time, pricing for sales transactions could match seller expectations.

The mountain of capital that has been sitting on the sidelines since late 2007 is primed to be deployed, as the enticement of a spike in senior debt mortgage interest rates and the prospects of greatly enhanced returns is emerging. Even core investments made during past periods of market stress typically have achieved double digit returns or 5% above real estate's long-term averages. For the wise investor who recognizes opportunity when others are spooked, this is the time to begin carefully planning the strategy for a market ready to reward those who price risk appropriately and are not afraid to act.

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