PCCP Market Commentary
Where Are All The Specialty Lenders?
First Quarter 2012

Over the past two years, the core commercial real estate ("CRE") market has recovered. Equity investors with dry powder have sought out stabilized properties with strong locations, high occupancy rates *and* in-place cash flow. While CRE lending volume is still a fraction of pre-crash levels, most lending has consolidated among the major banks, life insurance companies and agencies (or "traditional" lenders) that are focused on core assets, thus creating a highly efficient market.

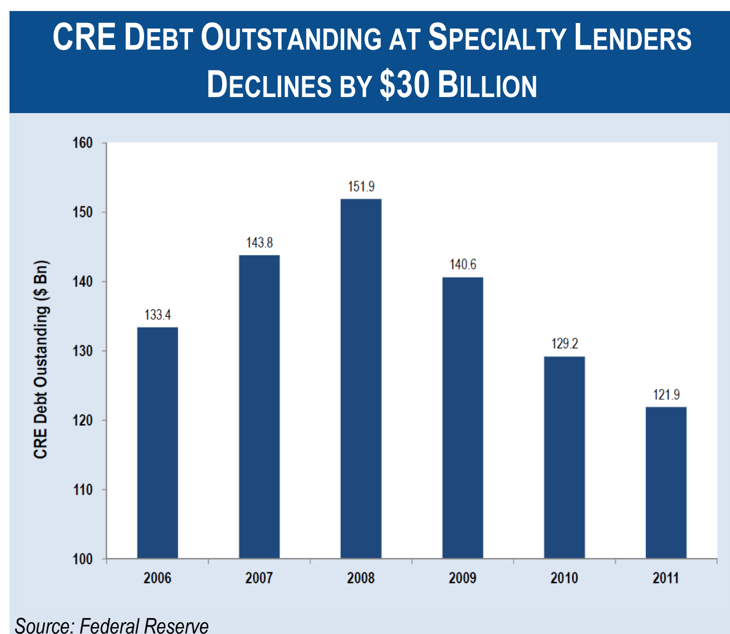
While the impact of the financial market crash on traditional lenders has been widely publicized, there has been little coverage of the far greater impact on specialty lenders, including mortgage REITs, industrial credit companies, and finance corporations. In our view, the crash had a greater impact on CRE specialty lenders, as most of them have left the market, materially reduced originations or have been priced out of the core markets by traditional lenders. While they hold less than 10% of CRE debt, their market presence is critical for value-add investors, especially given today's heightened credit underwriting and the inflexibility of traditional lenders. If distressed assets are going to continue to come to market seeking recapitalization, the presence of specialty lenders in the market is vital. The situation today creates a strong opportunity for new lenders with capital.

Specialty Lenders for Commercial Real Estate

As CRE boomed in the mid-2000s, the lending industry saw corresponding growth and diversification. Specialty lenders for CRE included industrial credit companies (GE, Textron, and GMAC), finance companies (CIT, iStar Financial, and CapSource), and mortgage REITs (Northstar, Arbor, Capital Trust, Anthracite, CBRE Realty Finance, and Gramercy, among others). These lenders relied heavily on short term borrowings through unsecured/secured term facilities, commercial paper, and/or CDO financing, which led to a classic case of asset/liability duration mismatch, or borrowing short while lending long.

Impact of the Crash on Specialty Lenders

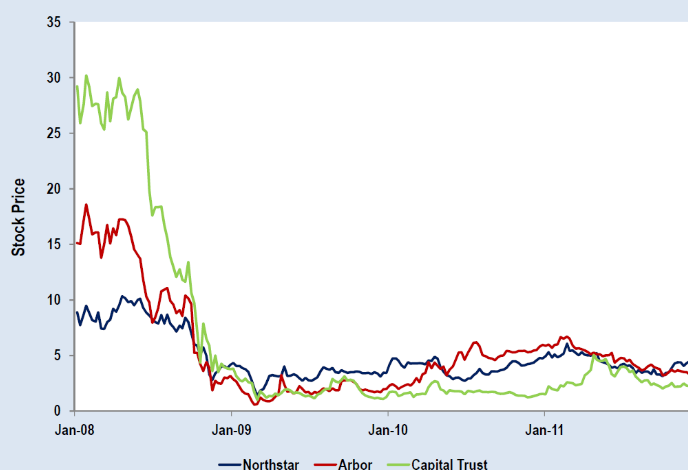
The financial crash of 2008 hit every part of the CRE industry and these lenders were no exception. Borrowing costs surged, available credit was sharply curtailed, and loan losses triggered negative covenants on outstanding lines/term facilities. Specialty lenders were hit on both sides of the balance sheet with non-performing assets creating losses and a non-existent financing market to match their liabilities. The aggregate CRE loan balance among specialty lenders shrank 20%, or $30 billion, from 2008 to the 3rd quarter of 2011[1].



Source: Federal Reserve

[1] Federal Reserve Flow of Funds Report 3rd Qtr 2011

Some specialty lenders went bankrupt (CapMark, CIT) or were close to bankruptcy (iStar). GE embarked on a massive balance sheet reduction with outstanding mortgages dropping from $47 billion in 2008 to $40 billion in 2010[2]. Mortgage REITS saw their stocks drop to zero, effectively shutting them out of the equity markets. With the closing of the CDO market and precipitous drop in stock prices, mortgage REITs lacked the ability to raise new capital for lending. Total CRE debt held by mortgage REITs dropped from $42 billion in 2008 to $34 billion as of the 3rd quarter of 2011[3]. The only source of capital for new lending was from CDOs, which typically have a 5-year reinvestment period allowing recycling of funds to originate new loans. With the last CDO issued in August 2007, the last reinvestment period will end in 2012, spelling the end of CDO-backed originations.



Current Status and Opportunity

Finance companies such as iStar are largely still out of the market. GE is only now getting back into the market and overall lending capacity is very much limited across specialty lenders. Three new mortgage REITs (Colony, Starwood, and Apollo) launched in 2009 to raise public capital for new CRE loan originations. However, their growth has been limited and the available capital is a small fraction of the amount compared to historical levels from mortgage REITs. In fact, these three REITs make up 50% of the total mortgage REIT market cap of $5.1 billion today, but this total market cap is less than 50% of the peak market cap of $10.4 billion in February 2007[4]. Given their current stock prices and implied cost of capital, material growth or new entrants in the market is highly unlikely at this time. Nor have the legacy mortgage REITs recovered from the crash or been able to pursue new business opportunities.

NEW MORTGAGE REITS STRUGGLE TO RAISE TARGET CAPITAL AND INCREASE SHARE PRICE

Mortgage REIT	Colony	Starwood	Apollo
Target Capital Raise	$500 million	$500 million	$400 million
Actual Capital Raised	$250 million	$810 million	$200 million
IPO Stock Price	$20.00	$20.00	$20.00
Current Stock Price (12/26/11)	$16.18	$19.00	$13.80

Sources: SEC; Yahoo Finance

[2] GE Annual Report 2008-2009-2010
[3] Federal Reserve Flow of Funds Report 3rd Qtr 2011
[4] Yahoo Finance and REITWatch

Further compounding the lack of debt capital in the market has been the slow recovery of the CMBS market and continued distress experienced by the top commercial banks because of their exposure to the residential housing market along with CRE exposure. What about the highly publicized CMBS 2.0 market? The total issuance in 2011 of $30 billion is nearly triple the $12 billion issued in 2010[5]. However, this is only about 10% of 2007's peak issuance and the market faces significant challenges related to federal regulations, rating agencies, and market volatility. We expect that appetite for CMBS securities will remain limited given the market spread volatility created by global macroeconomic issues.

From the lending perspective, the absence of specialty lenders provides a tremendous opportunity for non-bank lenders with ample dry powder and an existing balance sheet. Banks, insurance companies, and the GSEs are focusing on higher quality stabilized assets while the CMBS market is unreliable for today's borrowers. As banks continue to workout and liquidate problem assets (see PCCP's Market Commentary pieces from the third and fourth quarters of 2011), the demand for specialty lenders will increase. Lenders with speed, flexibility, and experience with workouts and recapitalizations are positioned to prosper. From the equity perspective, nimble investors with the ability to navigate specialty lenders are able to transact despite the perceived deadlock. Now is the time to capitalize on the inefficiencies within the distressed and recapitalization markets.

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[5] Commercial Mortgage Alert