The Real Estate Meltdown

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Causative Factors

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- CRE expansion cycle too long
  - “Rule of 38s”: 17-year bankers had never experienced meaningful downturn
- Post 9/11, highly accommodative monetary policy
  - Exceptionally low interest rates
    - Markets flush with liquidity
  - Investor anxiety for income

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Causative Factors – (continued)

- Originate to distribute model lessens focus on underwriting
  - Market's voracious appetite for risk absorbs what originators can produce
  - CMBS creates "risk-free" mentality
    - Backed by hard assets
    - Collateral appreciates in value
    - Capital markets accommodate refinancing
  - Transaction fees trump transaction fundamentals

- Underwriting standards plunge
  - No equity/deferred equity
  - 3 – 5 years interest-only, 30 year amortization
  - High LTVs

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Industry Impact

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- Severe absence of liquidity
  - CMBS market remains moribund
  - Banks shedding assets vs. lending
  - Large volume of maturities next several years
    - Today's underwriting standards vs. '05 – '07
- Appraisals in downward cycle
  - Distressed sales driving comps
  - Cap rates stubbornly high
  - Extended time to sell
- Regulators not exacerbating problem
  - No cap rate substitution
  - Cash flow drives rating, not LTV

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