Wall Street is Back to Printing Money & Paying Big Bonuses. Are You Sharing in this New Found Prosperity?

Institutional real estate investors, many of whom have been severely burned over the last couple of years, can rightfully point a chiding finger at the so-called "big league managers" who not only failed to foresee the commercial real estate (CRE) collapse as professional and experienced money advisors, but also benefitted from positive cash flows by putting investors' money at stake. CRE investors have, through institutional funds, basically given these money managers a cost free "call option" on the real estate market by funding the vast majority of equity in acquisitions and allowing fund managers to benefit from upfront acquisition and management fees as well as a share of investment gains contingent upon success. The fee structure incentivizes management in certain circumstances, to raise as many funds and do as many deals as possible, in lieu of focusing on being as profitable as possible. This is one of possible explanations for the flurry of fund raising and deals executed between 2004 and 2007, when the CRE market reached the crescendo of a bubble peak.

CRE prices have corrected sharply since the peak (nearly 45% from October 2007) and have substantially reduced, if not eliminated investors' capital in highly reputed real estate funds such as MSREF, floated by Morgan Stanley. The multiple conflict of interest between the fund sponsor (the manager) and investors is illustrated clearly in such funds, and arose from the fact that fund sponsor was compensated on the basis of deals done (acquisition fees) and funds under management (management fees), making them extremely aggressive in fund acquisitions. Consequently, the aggressive deals (in an attempt to rake in huge amounts in fees), which were done at highly unreasonable and unsustainable valuations, are now standing as underwater holdings, liable for foreclosure and liquidations due to the illiquid capital markets, and high LTVs that are the inescapable result of such rampant speculation.

Dec. 17 (Bloomberg) -- Morgan Stanley, the securities firm that spent more than $8 billion on commercial property in 2007, plans to relinquish five San Francisco office buildings to its lender two years after purchasing them from Blackstone Group LP near the top of the market.

[The properties were] held by the bank's MSREF V fund. "It's not surprising this deal ran into trouble," Michael Knott, senior analyst at Green Street Advisors in Newport Beach, California, said in an interview. "It was eye-opening among a group of eye-opening deals. There was almost no price too high in 2007 for office space in top gateway markets."

The San Francisco transfer would mark the second real estate deal to unravel this year for Morgan Stanley, which bet on the property markets as prices were rising. The firm last month agreed to surrender 17 million square feet of office buildings to Barclays Capital after acquiring them for $6.5 billion in 2007 from Crescent Real Estate Equities. U.S. commercial real estate prices have dropped 43 percent from October 2007's peak, Moody's Investors Service said last month.

… The Morgan Stanley buildings may have lost as much as 50 percent of their value since the purchase, Knott estimated.

Operational Underperformance versus the Implicit Call Option: Does the Funds' "House" Always Win Cause GPs to Pursue Deals Regardless of Profitability?

From Pensions & Investments:

Morgan Stanley, once a giant in the real estate business, is in a world of hurt.

Among the wounds afflicting the Morgan Stanley Real Estate group:

•Morgan Stanley is writing down 80% of the properties in Fund V U.S. and 60% in Fund VI International.

•Two investors — the $60.5 billion New Jersey State Investment Council and the $3.86 billion Contra Costa County Employees Retirement Association — backed out of their commitments to its latest closed-end fund, the approximately $5 billion Morgan Stanley Real Estate Fund VII. Contra Costa had committed $75 million; New Jersey, $150 million.

•Its $5 billion open-end core real estate fund, the Morgan Stanley Prime Property Fund, has a line of investors asking for a total of more than $500 million in redemptions as of year-end 2008. The fund returned -19.8% for the 12 months ended March 31, underperforming the NCREIF Property index but outperforming the NCREIF Open-End Diversified Core Equity index, according to fund information provided to investors.

•Crescent Resources LLC, a joint venture between Morgan Stanley Real Estate Fund V U.S. and Duke Energy Corp., filed for Chapter 11 bankruptcy protection to reduce the debt level and improve the capital structure. Investors in Fund V include the $40 billion Pennsylvania Public School Employees' Retirement System, $119 billion California State Teachers' Retirement System and $6.2 billion San Bernardino County (Calif.) Employees' Retirement Association.

While the aggressive acquisitions made during the bubble phase can be taken as a flawed investment strategy, the fact that fund managers intentionally structured their products as a win-win situation for themselves cannot be pardoned, or ignored. The fact becomes even more significant since the signs of a bubble were so obvious to objective parties. Reggie Middleton clearly outlined the risks of the CRE bubble in 2006 and 2007, the years in which CRE funds were making their largest investments ever! As a matter of fact, Mr. Middleton warned of the risks of the Blackstone portfolio in 2007, the very same portfolio that Morgan Stanley, through their MSREF V fund, was forced to disgorge at a near 100% equity loss to LP investors who did not have the benefit of an implicit "call option" on the CRE market (see sidebar on the left). Needless to say, Morgan Stanley, the GP and effective holder of the "Call Option", actually saw significant cash flow from carried interest, management and acquisition fees despite its investor's losses. Refer to the link "Doesn't Morgan Stanley Read My Blog?" for more information on Mr. Middleton's prescient warning on the dangers of purchasing that particular portfolio in 2007.

Several similar warnings were made during that era, all currently available for reference via the following hyperlinks:

- Will the commercial real estate market fall? Of course it will. **09 December 2007**
- Do you remember when I said Commercial Real Estate was sure to fall? **20 December, 2007**
- The Commercial Real Estate Crash Cometh, and I know who is leading the way! **06 January 2008**

Upon a close examination of the structure of funds such as the Morgan Stanley's MSREF, it has been observed that fund sponsors, acting as the GP (general partner) collect sufficient cash flows through fees to insulate themselves from negative returns on their equity contribution in the case of a severe price correction *(Please refer to the hypothetical example below, constructed as an illustration of a typical real estate fund)*. The annual management fees (usually 1.5% of the committed funds) along with acquisition fees provide the cash flow cushion to absorb any likely erosion in the capital contribution (usually 10% of the total equity). Further, the provision of "GP promote" (the GP's right to a disproportionate share in profits in excess of an agreed upon hurdle rate of return) rewards the fund sponsor in case of gain, but does not penalize in case of a loss. Herein lies the “Call Option”! With cash flows increases that are contingent upon assets under management and the volume of deals done combined with this implicit “Call Option” on real estate, the incentive to push forward at full speed at the top of an obvious market bubble is not only present, but is perversely strong – and in direct conflict with the interests of the Limited Partners, the majority investors of the fund!

A hypothetical example easily illustrates how the financial structure of a typical real estate fund is so tilted to the advantage of the fund sponsor as to be analogous to a cost-free “Call Option” on the real estate market.

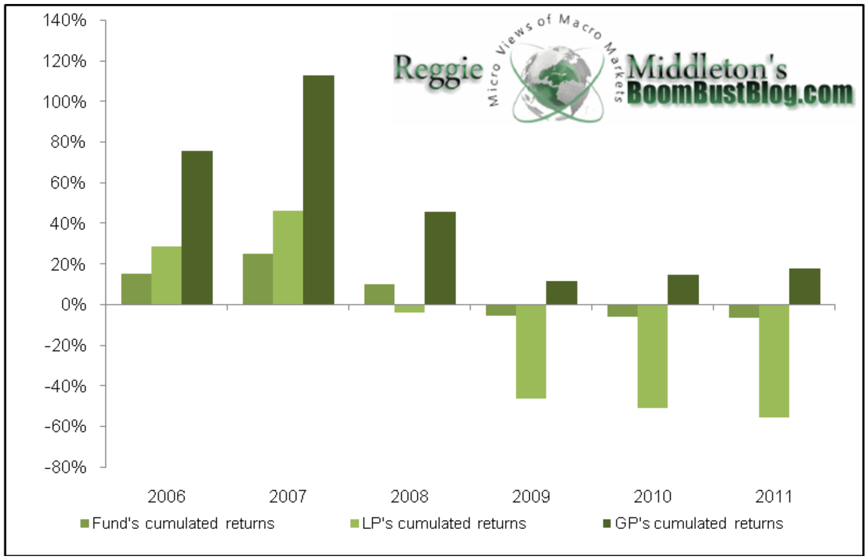
The example below illustrates the impact of change in the value of real estate investments on the returns of the various stakeholders – lenders, investors (LPs) and fund sponsor (GP), for a real estate fund with an initial investment of $9 billion, 60% leverage and a life of 6 years. The model used to generate this example is freely available for download to prospective Reggie Middleton, LLC clients and BoomBustBlog subscribers by clicking here: Real estate fund illustration. All are invited to run your own scenario analysis using your individual circumstances and metrics.

Example of financial structure of a typical real estate fund	
Leverage	60.0%
Managememt fees (same as MSREF V International)	1.34%
Acquisition fees (same as MSREF V International)	0.74%
GP pomote (same as MSREF V International)	17.4%
Hurdle rate	10.0%
Vaue of property purchased (in $ mn)	9000.0
Debt raised(in $ mn)	5400.0
Interest rate	5.0%
Equity (in $ mn)	3600.0
Investors - LPs - 90%	3240.0
Fund sponsor -GP - 10%	360.0

To depict varying impact on the potential returns via a change in value of property and operating cash flows in each year, we have constructed three different scenarios. Under our base case assumptions, to emulate the performance of real estate fund floated during the real estate bubble phase, the purchased property records moderate appreciation in the early years, while the middle years witness steep declines (similar to the current CRE price corrections) with little recovery seen in the later years. Following table summarizes the assumptions under the base case.

Base case	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Change in value of property	*10.0%*	*5.0%*	*-20.0%*	*-20.0%*	*-5.0%*	*-5.0%*
Operating cash flows	*5.00%*	*5.00%*	*4.75%*	*4.50%*	*4.50%*	*4.50%*
Total return	*15.0%*	*10.0%*	*-15.3%*	*-15.5%*	*-0.5%*	*-0.5%*

Under the base case assumptions, the steep price declines not only wipes out the positive returns from the operating cash flows but also shaves off a portion of invested capital resulting in negative cumulated total returns earned for the real estate fund over the life of six years. However, owing to 60% leverage, the capital losses are magnified for the equity investors leading to massive erosion of equity capital. However, it is noteworthy that the returns vary substantially for LPs (contributing 90% of equity) and GP (contributing 10% of equity). It can be observed that the money collected in the form of management fees and acquisition fees more than compensates for the lost capital of the GP, eventually emerging with a net positive cash flow. On the other hand, steep declines in the value of real estate investments strip the LPs (investors) of their capital. The huge difference between the returns of GP and LPs and the factors behind this disconnect reinforces the conflict of interest between the fund managers and the investors in the fund.



	Fund's return			
	Operating cash flows	Change in value of property	Total returns	Cumulated total returns
Year 1	5.00%	10.0%	15.00%	15.00%
Year 2	5.00%	5.0%	10.00%	25.00%
Year 3	4.75%	-20.0%	-15.25%	9.75%
Year 4	4.50%	-20.0%	-15.50%	-5.75%
Year 5	4.50%	-5.0%	-0.50%	-6.25%
Year 6	4.50%	-5.0%	-0.50%	-6.75%

LP's return on 90% of equity contribution			
Profit distribution	Capital gains/ losses	Total returns	Cumulated total returns
5.0%	23.4%	28.36%	28.36%
5.0%	13.0%	18.03%	46.39%
4.9%	-55.4%	-50.53%	-4.14%
4.2%	-46.2%	-42.03%	-46.17%
4.2%	-9.2%	-5.07%	-51.25%
4.2%	-8.8%	-4.61%	-55.86%

	GP's return on 10% of equity contribution				
	Profit distribution	Management fees/ Acquisition fees	Capital gains/ losses	Total returns	Cumulated total returns
Year 1	5.0%	30.6%	39.8%	75.36%	75.36%
Year 2	5.0%	12.1%	20.2%	37.29%	112.65%
Year 3	0.0%	12.1%	-79.0%	-66.97%	45.68%
Year 4	0.0%	12.1%	-46.2%	-34.14%	11.54%
Year 5	0.0%	12.1%	-9.2%	2.82%	14.36%
Year 6	0.0%	12.1%	-8.8%	3.28%	17.64%

	Total cumulated returns over 6 years		
	Fund	LP	GP
Optimistic case	9.25%	-26.58%	46.91%
Base Case	-6.75%	-55.86%	17.64%
Adverse case	-16.75%	-72.64%	0.86%

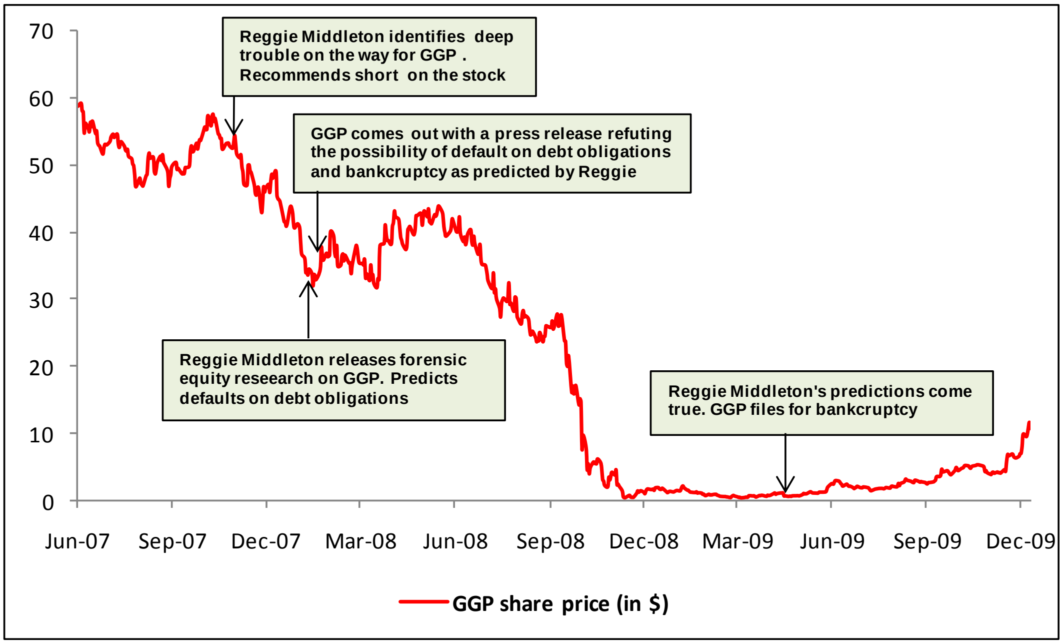
Under the base case assumptions, the cumulated return of the fund and LPs is -6.75% and -55.86, respectively while the GP manages a positive return of 17.64%. Under a relatively optimistic case where some mild recovery is assumed in the later years (3% annual increase in year 5 and year 6), LP still loses a major chunk of the capital invested while GP earns a handsome return. Under a relatively adverse case with 10% annual decline in year 5 and year 6, the LP loses most of its capital while GP still manages to breakeven by recovering most of the capital losses from the management and acquisition fees..

Reggie Middleton can help…

Instead of relying on fund managers who have not only proven to be extremely inaccurate but also influenced by the conflicting interests of their firm, you can profit from the insight and expertise of a thorough professional and extremely accurate real estate expert. Mr. Reggie Middleton has been one of the few industry experts who have been early and consistently accurate in measuring the credit risk plaguing the residential and commercial real estate sector, as well as the effects that it would have on the banking and real estate industries. After sounding the alarm on commercial real estate almost two years ago, he singled out the largest of all commercial real estate failures a full year in advance. General Growth Properties was picked to be the big shorting opportunity in November 2007, when it was the 2nd largest commercial mall owner in the country, trading above $60, with an investment grade rating and buy recommendations from Wall Street. It filed for bankruptcy a year and a half later.

The following hyperlinks lead to the extraordinary body of research performed by Mr. Reggie Middleton surrounding GGP (click each link below to access content):

- The Commercial Real Estate Crash Cometh, and I know who is leading the way! **06 January 2008**
- Generally Negative Growth in General Growth Properties - GGP Part II **08 January 2008**
- General Growth Properties & the Commercial Real Estate Crash, pt III - The Story Gets Worse **09 January 2008**
  More on GGP: A Granular View of Insider Selling and Lease Rate Growth **11 January 2008**
- GGP part 5 - The Comprehensive Analysis is finally here **19 January 2008**
- My Response to the GGP Press Release, which seems to respond to blogs... **21 January 2008**
- For those who were wondering what sparked that silly press release from GGP. **22 January 2008**
- GGP: Foreclosure vs Asset Sale **25 January 2008**
- GGP Refinancing Sensitivity Analysis **25 January 2008**
- GGP part 7 - Share value under the foreclosure analysis **31 January 2008**
- GGP part 8 - The Final Analysis: fire sale of prime properties **02 February 2008**
- GGP Conference Call **14 February 2008**
- Reader's legal observation on GGP **16 March 2008**
- Analysis of GGP's recent Q1 results **29 April 2008**
- GGP Can't Afford its Dividend **06 May 2008**
- Press release announcing new equity financing - **21 March 2008** something that I didn't explicitly model in my own analysis, but after reviewing information without the benefit of official documentation, there were no surprise nonetheless... **26 March 2008**
- We did find some surprises, and my blog readers chimed in with their expertise and opinions... **12 April 2008**



Mr. Reggie Middleton evaluates the total credit risk attached to the CRE portfolio by a) following a bottom up approach wherein each individual property is valued based on current cap rates and prevailing rentals b) comparing the fair value of each property with outstanding mortgage to identify the pockets with high LTV, which can lead to losses on liquidation c) factoring in the refinancing risk arising from short-to-medium term scheduled maturities.

Similar foresight and performance is publicly documented in Mr. Middleton's calls across several industries that invest in, loan against, develop or indemnify real estate and real estate related assets, including:

1. The residential home builders (producing publicly available forensic analysis in 2007 that accurately forecasted in detail these companies predicaments and off balance sheet liabilities at a time when they were heavily favored by Wall Street analysts (download a sample report - Lennar Forensic Analysis and Valuation update - 2/2009 2009-02-23 09:12:53 485.65 Kb,

2. The fall of the monoline insurance industry that insures mortgages and mortgage derivative products, wherein Mr. Middleton predicted the fall of the two largest insurers in 2007-08 when they had AAA credit ratings and share prices north of $80, both now flirting with bankruptcy after a 95% drop in share price (Sample report: Assured Guaranty Consolidated 2008-11-22 06:29:28 796.13 Kb

3. The problems inherent in the regional banks due to high concentration of exposure in the second lien residential loans and commercial real estate. Mr. Middleton produced a list of 32 banks in the spring of 2008, before the Wall Street analysts, consultants and media sounded the alarm. Every bank on that list has exhibited signs of distress ranging from multi-billion government bailouts to 60% to 95+% share price drops to absolute failure/fire sale takeover/receivership. See "How Regulatory Capture Turns Doo Doo Deadly!" for a recent blog post on the topic.

As can be seen from above, Mr. Middleton and his analytical team has a very rich history of accurately analyzing exactly what brought about this crisis, what the effects of the crisis would be, and who would be affected as well as how. Unlike many pundits, Mr. Middleton has managed to do this "before the fact", and is now (and for the first time) offering consultative solutions to a select group of prospective clients.

Service Offerings in the Commercial Real Estate Space

Mr. Reggie Middleton and his team offer customized research to help investors arrive at a fair value of their CMBS holdings. In particular, the services include:

1. Macroeconomic and fundamental strategic planning: preparing for both a protracted real asset decline and the possibility of a "V" shaped asset recovery

2. Valuation of CMBS holdings by modeling the future cash flows while discounting the expected defaults on the underlying mortgages.

3. Risk assessment of the various tranches while building-in estimated subordination levels.

4. Estimating losses from term defaults and maturity defaults based on the estimated property wise debt-to-service coverage ratios and LTV levels.

5. Detailed scenario analysis for depicting the estimated payouts in case of special servicing, loan work-outs and liquidations.

6. Detailed scenarios analysis for impact of changing market conditions like liquidity and regulatory changes, on asset pricing.

7. Custom engagements designed on an ad hoc basis.

Mr. Middleton will entertain the possibility of taking on equity ownership and/or higher level debt as partial compensation for certain engagements.

If you are interested in our research and/or consultation services, you may reach out directly to Reggie Middleton:

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Micro Views of Macro Markets

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