



## **31<sup>st</sup> ANNUAL MARSHALL BENNETT CONFERENCE**

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### **Roundtable II**

*Comments of Attendees  
as reported  
by Mathew A. Wyman of  
Cox, Castle & Nicholson LLP*

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**June 23, 2009**

**Peter Linneman** opens the second session with three observations from yesterday: (1) everybody seemed to agree on the state of the market, (2) all agreed that the state of the market was lousy, and (3) that the only way out is economic recovery and increased capital flows.

**Peter** then turns to **Tony Downs** and asks him to start with a discussion on the general economy and the threat that inflation poses. **Peter** notes that there have been predictions of both huge inflation and deflation and asks **Tony** to comment.

**Tony** begins by stating that he just happened to write a book on the subject called "*Real Estate and Finance in Crisis*." It is for sale on Amazon.com and he requests that the entire group buy the book, although he does not care if they read it. **Tony** continues with four scenarios.

The first is that the recession will end in 2009 with little risk of significant inflation. He puts a 15% probability of this scenario occurring.

Next, the recession ends in late 2009-2010 with a slow recovery. Again, little risk of significant inflation. He puts a 65% probability for this scenario.

The third scenario is the recession ends in 2009-2010, but the dollar experiences a significant decline in value, driving high levels of inflation and interest rates and pushing the economy back into a deep recession. He puts the probability of this scenario at 8%.

Finally, fourth, we come out of the recession relatively early in 2010 through government spending programs. However, the spending drives inflation, which in turn, causes an increase in interest rates and results in the economy dipping back into a mild recession. **Tony** sees a likelihood of 12% for this scenario.

**Dan Neidich** asks **Tony** how much inflation is he predicting. **Tony** responds that inflation should be around 7%. **Dan** then asks how inflationary a weak dollar would be. A weak dollar will expand exports and devalue reserve currencies held by China. This will have an inflationary impact.

**Tony** continues that Federal spending will not really hit until 2010-2011. As a result, any inflation impact will be delayed. We need Federal spending because of the drop in consumption and investment. The drop in consumption, while detrimental in the short run, ultimately will be helpful in addressing the other spending priorities with the aging of the baby-boomers between 2010 and 2050. This includes the cost of Medicare, Medicaid and Social Security. The real trick will be how the government will cut back its spending if consumption rises.

**Steve Ross** of Related asks **Tony** to comment on the impact of excess capacity in goods and services caused by the recession. **Tony** responds that excess capacity will be absorbed by increased spending, which will in turn impact inflation. **Steve** then asks, if we are in an era of less leverage, will that moderate inflation?

**Tony** responds that the deleveraging will reduce the capacity to lend and refinance loans as they come due, particularly those made in 2005 and 2006.

**Michael Pralle** asks **Tony** whether consumers being weak will help moderate inflation. **Tony** agrees. Further, consumers are deleveraging. This will all provide a moderating impact on inflation. Finally, a near term reduction in consumption would be good since we need to place our spending priorities elsewhere in light of the aging of the baby boom population.

**Barry Sternlicht** asks **Tony** why scenario 3 has the lowest probability.

**Tony** responds that these are totally subjective and, as all such predictions, really cannot be defended. **Tony** adds that he does not believe that wage pressure will be a factor. The real concern is that the Fed will put too much money into the economy and will not be able to control inflation before it sets in.

Regarding the housing market, **Tony** does not see a recovery right away. Housing starts are down 80%. However, housing prices reported by most of the indexes are not

accurate. For instance, the *Case Schiller Index* only covers 20 markets and includes foreclosure prices. Both of these distort the real story.

That said, the housing market will not come back until 2011. Last year, there were 3,000,000 filings for foreclosures. This year, there will be more.

**Sam** interjects asking whether the impact in increased saving rates could create more capital for the system. **Tony** says yes, but this will be absorbed quickly in order to increase the necessary lending capacity.

Finally, regarding employment, **Tony** believes that unemployment will rise through 2010 and it will take three to five years to recover to a more normal employment situation.

**Peter** then asks **Ken Rosen** whether there is a good case to be made that high levels of inflation will occur.

**Ken** observes that we have been in a great recession for the last nine months. However, that has stopped. By the end of the year, we will either have a mild recovery or a mild recession. He also agrees with **Tony** that inflation this time around is a monetary phenomenon and will not be driven by wage pressures. We have excess capacity. He is sure **Bernanke** will stop printing money if he sees inflation beginning to develop. However, the large Federal deficits will continue to expand and this will be a world-wide phenomenon. Two years from now, he predicts an inflation rate of around 5%, which is not all that bad. He does not believe that inflation will get to 10%.

**Ken** continues that, right now, interest rates are artificially low. However, **Bernanke** has said on numerous occasions that when the economy gets going again, rates will increase. **Ken** sees the 10 year bond moving to around 6%. We are already seeing higher rates driven by inflation expectations. **Ken** concludes by summarizing that the biggest risk is **Obama** trying to replace **Bernanke** because of political pressure to keep the economy growing.

**Peter** next asks **Joe Gyourko** to provide his views on the inflation situation.

**Joe** agrees with **Ken** and **Tony** that inflation is a monetary problem. Right now, we have huge reserves. He feels that inflation will be 2% for the next couple of years. The wild card is what happens if the dollar drops. That could happen. But in his view, it would not, under any circumstance, happen in the next year or so. We need to get our financial house in order. We will run 10-15% Federal deficits this year and next. However, if these deficits continue into a third year, they will begin to have accumulated Federal deficits approaching 100% of GDP. If that happens, there will be significant increases in interest rates. In fact, he believes Britain is experiencing this problem right now. He agrees with **Ken** that the appointment of the Federal Reserve Chair is critical to address this problem. The reserves are huge and ultimately they need to be withdrawn.

**Peter** then asks **Ron Sturzenegger** to comment on the state of banking industry, asking "What if rates bounce up in the next 2 to 3 years?"

**Ron** replies that would not be a good result. Right now, the Fed has been our friend in keeping rates low. Ironically, prior to the recession, the Fed was not acting in our best interests by keeping rates too low contributing toward the unsustainable economic expansion. This was evidenced by price increases for real estate while NOI stayed relatively flat.

**Ron** continues that many of their loans were made on a low floater basis. If rates go up, these assets will not be able to cover debt service. In terms of dealing with banks, borrowers can kick the can down the road if they keep interest current. However, if rates go up and borrowers cannot pay interest, then banks will need to take these assets back.

**Ron** acknowledges that the Feds have largely cooperated with both the regulated and non-regulated banks. Addressing borrower frustration with commercial banks, Ron reminds the group that they are required to follow regulations, even when sometimes it is not their choice to do so. In the coming months, **Ron** believes the banks will spend a lot of time on the appraisal process. Appraisals are necessary to extend their loans and if the appraisals come in too low, it will require them to take reserves. He believes that the current appraisal process does not adequately reflect the value of the assets.

**Dan Neidich** asks **Ron** if he will extend NPLs. **Ron** replies that they will extend non-performers, if possible. It does not help to take loans back if for no other reason that to do so will just put more downward pressure on values. He is trying to avoid this

downward, vicious cycle. **Ron** closes that it used to be “amend and extend”, now it is “amend, extend and pretend”.

**Joe Azrack** asks, “What ability does Bank of America have to make new loans?” **Ron** responds sarcastically, “What do you mean, new loans? There are no new loans. Put that out of your mind.” **Ron** informs the group that B of A recently announced making \$12 billion in loans this year. However, \$11 billion were really renewals and \$1 billion mostly represented advances Bank of America had to make in situations where they were the lead bank and one of the other banks in the syndicate failed to fund its share of the loan draw. He adds that you cannot really blame the banks for not making new loans when no one is paying existing loans back. He continues that while everyone wants to blame the banks, the fact of the matter is that the fundamentals in real estate are poor. If that were not the case, most of the people in this room would be buyers. So if no one here is a buyer in the current market, why should he be a lender?

**Sam Zell** responds, sarcastically, that lenders are always supposed to be dumber. **Ron** responds jokingly that “history has proven him right.” **Ron** continues that there has been some positive signs in the banking industry in terms of their ability to raise capital the last couple of months. **Ron** observes that being public has been a benefit in the current situation, noting that REITs have been able to raise \$14 billion of new capital in the public markets. Private companies have not had access to this type of capital. So, as

a result, B of A has been willing to work with public companies like REITs and have had a harder time working with private companies.

A member of the group asks, that in light of the reluctance to take marks on their portfolio, is there any appetite for joint ventures where they might mark only half of the required write-down and convert the balance of what would otherwise be written down to equity. **Ron** says maybe, but they just have not had a lot of time to focus on ways to deal with the problem. He adds that unlike the last time around, this recession is not all about the real estate industry. Commercial real estate is the largest asset class at 12-15% in Bank of America's loan portfolio, but it is not the only problem. It is important for this group to understand that commercial real estate is not the total focus.

**Peter** then turns to **Jon Vacarro** and asks for his views on the banking industry.

**Jon** responds that they are focusing on what part of their portfolio will be impaired. They have been taking a hard look at NOI and it has been going down. Most of the top ten banks will be able to handle these loans problems. However, community banks are under much more stress. He believes that 700 of these banks could be taken over by the FDIC when all is said and done. However, he worries that FDIC does not have the resources to deal with the magnitude of the problem. The FDIC is also encumbered by politics. They are working on a commercial loan program, but it is not fully developed. **Jon** believes that most banks do not really need to exist. It would probably make sense with many of these to simply shut the banks down, transfer the deposits over to a larger

bank and dispose of the assets. There is some talk of restarting the RTC. If this happens, however, there will be further declines in value. Instead, the game continues to be to extend loans. But at some point, banks will probably have to get to the auction blocks. There is no bank in the world that is unaffected by this problem. Europe is worse, much worse. There are fewer banks and, therefore, more concentrated risk. Two of the three banks in the UK are essentially shut down. In Germany, Hypo-Real Estate has effectively been nationalized and Euro-Hypo has been shut down. The bond market has reopened a bit, but only in a covered bond structure which is not a very efficient mechanism since the bank must carry the entire loan on their books.

**Jon** states that Japan is not suffering that much since it did not experience the same boom. In Japan, the government is looking to make loans to JREITs which currently are selling at very low levels. Japan is a tough place to do business because of all the regulation. There effectively is no securities market in Japan right now.

**Peter Linneman** asks whether the effective nationalization of lenders has made these banks take a more inward focus.

**Jon** responds that a lot of nationalism is going on and, as a result, there is a regulatory arbitrage around the world. Everyone is out to protect to their turf. In the United States alone the government has committed over \$15 trillion to prop up the system.

**Peter Linneman** turns to **Peter Bacille**.

**Peter** starts with noting that the focus is on longevity. Right now, banks are just trying to find a way to survive. They have not yet begun the clean-up of all the bad banks. In the '90's, we lost 2,000 banks. Today, we have half as many banks and we will lose 1,000 more. Over 300 are on the watch list representing over a \$1 trillion in deposits. The recovery is still ahead of us. It took six to seven years to dig out of the '90's hole and this hole is much deeper. The new regulatory environment is "frightening". It will impact the securities market requiring extensive representations and warranties, the issuer to hold a piece of the investment and the elimination of the special purpose vehicle or "SPV".

**Peter** comments that, SPV's have been a fundamental part of the CMBS vehicle. Managed properly, it can provide significant liquidity. 40% of the loan market is gone. We are going to need to figure out how to replace \$2.5 trillion annually in lending. This will require a lot of technology to be developed and a lot of regulations to be figured out.

**Peter** then asks **Peter Bacille** whether we are doing the same thing that we criticized Japan for in the 1990's, i.e., Japan's refusal to cleanse the assets out of the system.

**Peter Bacille** responds that we cannot afford to do anything different.

**Peter Linneman** counters that Japan paid an 18 year price for not taking its medicine.

**Peter Bacille** responds that it won't take that long in the United States since we have a more diversified economy.

**Neil Bluhm** asks **Peter** what logic is there in getting rid of the SPV? **Peter** answers that, unfortunately it was the subject of abuse and, as a result, a lot of junk was issued.

**Dale Reiss** adds that the problem is that new regulations may require accounting that will effectively require the issuer of any of this debt to consolidate all of it on its books.

**Peter Bacille** adds, "We did \$20 to \$25 Billion of debt which we never could have done if we had to carry all of that on our books." **Peter** points out that while regulation will produce more creditworthy lending, it will make it more difficult to fill the hole that has been created by the loss of the CMBS market.

**Peter Linneman** asks **Jay Mantz** and **Barry Sternlicht** whether the public markets will be a solution.

**Jay** does not think it will. **Barry** responds that the private world will also be tough. Real estate is once again the kicking boy of the investors. The private equity guys just do a better job of "lying" than we do. There is a tug-of-war going on between the investors and real estate advisors. Investors provide advisors with conflicting messages regarding whether to mark their assets and by how much. Regarding the public markets, the stock market is the psychological template of the United States. As the market has improved, so has consumer spending. For instance, **Barry** is beginning to sell some condos at full price. With respect to investors, public markets give them liquidity. Investors favor the public market right now principally for that reason.

**Jay** adds that they are seeing public activity in China and India. There is capital in these countries. Europe may improve as well, but this will take the cooperation of the lenders. In China, banks are lending and public markets have responded. This is the only place where new loans are getting made.

**Michael Garfinkle** is then asked by **Peter** to comment on the status of hedge funds.

**Michael** opens that since September, and the failure of Lehman, there has been a mass withdrawal from the hedge funds. This was not necessarily related to performance. Many of these hedge funds had no choice and had to honor the redemptions. The drop in the securities market exacerbated the problem as many investors had allocation issues and had to decrease their alternative investments. As a result, some hedge funds became like ATMs if they did not have any “gates” built into their redemption system. They will be lucky if subscriptions begin to equal redemptions by the end of the year.

**Steve Ross** is then asked to comment on the Chinese market.

**Steve** says he is not trying to sell anybody on China. He has enough competition from the local Chinese. China is not in a recession. It is back to 7% to 8% GDP growth. They have made 20% more loans than this time last year. For instance, a new \$150,000,000 loan was recently made on a 35% leased building. The term was five years. Loans are typically being made in China at 50% to 60% LTV on a non-recourse basis. Valuations are typically at a 7% to 8% cap rate and interest rates are running from 5% to 6%. Other

aspects of the Chinese economy are doing well. Auto sales are up 55%, residential sales are up 25%. China is a vibrant market. Growth is now being achieved internally, represented by 50% domestic spending as opposed to 70% exports in the past. The Chinese are spending and the government is encouraging them to do so. There are few signs of U.S. or European investors entering this market. It simply takes people years to understand the growth story in China.

**Jay Mantz** counters that one big issue in China is office vacancy rates which are in the mid-20's with falling rents. **Barry Sternlicht** adds that luxury hotels are running at 40% occupancy. **Jay** adds that he is experiencing only 50% to 70% occupancy in their two star hotels. They have been unable to generate yield with any certainty. Further, the only takeout right now for these assets are Chinese investors from Hong Kong.

**Bill Mack** adds that they looked at China and India as a way to get solid risk-adjusted returns. India is coming out of its recession. Interest rates were high and the currency was hit pretty hard. However, the residential, office and retail markets are all coming back. The residential market appears to be the strongest. Land prices are now at more reasonable levels. Unlike in the past, there are good land values available. Land used to be 50% of project costs. This is not the case anymore. Today, there is more scarcity of capital. So they can take advantage of the lower land prices. He believes that the growth rate in India will be between 5% and 7% GDP. It looks like things are getting much better. The market right now for sellers is very liquid, but cap rates are high. If you are a

seller, it's probably better to hold. Another alternative is to develop out the projects as for sale residential which will generate higher rates of return than selling in bulk.

**Andy Jonas** adds that they viewed India and China as an alternative investment. However, now investors see the United States on sale. So there is less interest in India and China. The bloom is off the rose. The deals that were being done in India were ridiculous. China may be a bit different story. China has hard assets that are more difficult to come by. **Andy** admits that while they went to China more to get a premium for the additional risk, the premium never materialized. The reality is that it's very difficult to do business in these markets.

**Peter** then asks **Sam Zell** to comment on Brazil and Mexico.

On Brazil, **Sam** is a "raging bull." He is the largest real estate investor in Brazil in both the homebuilding, retail, distribution and net leasing product types. There are 180,000,000 people in Brazil. The country is energy self-sufficient. He likes the current government. The country is growing. Retail sales are up 12% this year. In terms of the residential market there are 10,000,000 units of demand for residential. Government financing is available to purchase these units. **Sam** compares it to Mexico where they built 100,000 homes in 2009. The history of Latin American as a place of hyper inflation is over. Lending is going on in Brazil. They expect GDP growth of 4% to 6%.

Regarding China and India, **Sam** points out that they are in China, but not India “thank god”. They decided to avoid India in light of their experience with the Santeum deal where, after spending some time with the principals in Chicago, **Sam** concluded that they were crooks. This, in fact, turned out to be the case.

**Sam** believes it is important to remember that we are in the middle of a demand recession. As a result, in order to be successful, we need to look for pockets in the world where there is demand. This demand exists in terms of low-cost housing in Mexico, China and Brazil.

**Jorge Perez** counters that they entered the Latin American market, but had to be very cautious because in places like Mexico, there are lots of problems. You need to chose partners very carefully. The politics and legal system are lacking. There is no transparency. Things can change very quickly. One day you have a building permit and the next day, a public official says that your building permit does not exist. The risk-adjusted rates of returns that investors were getting in Mexico did not make sense. Buying a Wal-Mart anchored center located in a low-income area of Guadalajara, for instance, at an 8% cap rate was inappropriate in light of the risk. In Latin America, it is not only the economic risk, it is also political risk.

**Sam Zell** responds that he could not agree more. However, they decided to trade the rule of law for growth. They also decided to make these investments through the public

markets. He believes that this provides some level of protection and enables them to raise capital.

**Peter Linneman** asks **Sam** if he is worried that these countries will nationalize his companies?

**Sam** responds that so far the public markets have been a very successful strategy in mitigating this risk. For instance, they recently did a secondary offering of their retail company in Brazil which was extremely successful. He admits, however, there is a big difference between Mexico and Brazil. Mexico has a very poorly-educated population, whereas Brazil has numerous well-trained executives. This distinction is critically important. In a recent net-lease deal with Colgate in Brazil, they achieved 16.7% unlevered returns with built-in inflation protections. **Sam** concludes that you really need to go outside the U.S. markets. There simply is not enough activity in the States.

**Peter Linneman** then turns to **Leon Bressler** asking him to comment on whether there are any attractive opportunities in Europe. Leon responds that you have to distinguish between the Euro-zone and the non-Euro-zone. Many went to countries in East and Central Europe to get better returns. Unfortunately, these markets are now the ones that are most impacted. The UK is obviously having major problems as well, with the financial services dragging down that market. On the other hand, the best opportunities will be found today in the mature countries. People do not need to go to the Ukraine

anymore to get decent returns. Germany, France and, to a lesser extent, Spain and the UK will provide these returns.

**Leon** also notes that in the Euro-zone, inflation is viewed as the more important risk. This is largely the result of the domination of the German anti-inflation policies resulting from its experience in the 1920's. They will fight inflation as a priority over growth. Unlike Brazil, the European countries have negative demographics. For this reason, he was surprised to see investors making bets on residential projects in Germany. Ultimately, he believes that opportunities will come in Europe. But right now, investors will have to wait and be patient.

**Steve Ross** of Related is then asked to discuss their activities in the emerging markets. **Steve** notes that they are developing in China and the Middle-East. In China, the first generation of developers that relied on the public markets have been decimated as a result of the downturn. They are looking to come back. The markets have improved, particularly in for sale housing. They are in Beijing and Shanghai. Related is not developing luxury product. No one intends to live in these buildings, which tend to be 40% to 50% vacant. Instead, there is an emerging working and middle-class market for residential product. He is hoping to achieve 20% to 35% returns by developing in this space. Related is working with local developers to buy land at auction. The Chinese love America. Related was invited over because the Chinese perceive that their company has

the technology and the quality brand. **Ken Wong**, one of their key employees, relocated to China to run their offices.

**Randy Rowe** adds his comments noting that this time around, it is very different than the 90's. We are deleveraging like the 90's, but then there were private companies who could access the public markets. Just like then, there was too large a gap to fill with just equity. As a result, the value of the assets in the 90's crashed. We filled that gap through a securitization system supported by the rating agencies. However, this approach proved to be deeply flawed. We learned from this experience that you cannot separate risk decision-making from capital investment. We need to realign capital and risk. This is already being done by the REITs. That is why they are being treated well in the capital markets. We need to de-lever by accessing the public markets to refinance the debt. The government programs being offered are really not the solution. They are only papering over the problem.

**Dan Neidich** observes that the last time around, there was cheap equity available to replace expensive debt. Now he wonders whether the opposite is the case.

**Andy Jonas** believes that the REITs may be the answer. REITs were able in the early 90's to pay down expensive debt with cheap capital. The same may happen now. The public side investors are looking for exposure to real estate.

**Richard Saltzman** counters that the equity, in fact, was expensive back in the 90's. The cost of capital was reflected in the dilution that was required, sometimes as much as 60%. There are parallels, but the economy is worse today because it is not just about us. However, there is more liquidity. Money market funds are up to \$4 trillion. That figure has doubled over the last four months. Yet there are worse fundamentals than there were in the 90's. This is a paradox that **Richard** struggles with. Nevertheless, the public markets remain the easiest place to raise capital.

**Peter Linneman** asks **Matt Lustig** for his comments.

**Matt** adds that the debt today is not so cheap when you mark to mark the assets. The severity of losses and defaults in the CMBS market are dwarfing the portfolio. The CMBS market will require higher rates going forward to reflect the lack of alignment of interest. Portfolio lenders are working through extensions. The CMBS originations in '06 and '07 are in really bad shape and there is no way out.

**Joe Azrack** adds that worldwide, governments have invested \$9 trillion to shore up the economy. While this has stabilized the private side, it will be a very long time before we clear off all of the bad debt. We have shored up the right side of the financial institutions' balance sheets, but until the left side is also taken care of, we will not recover from this problem. We need to reinvent the debt markets and we need to clear the assets. Unfortunately, there is still not enough capital. It will just take a long time, as long as five years.

**Dan Neidich** asks **Joe** if that means he is not buying for another five years. **Joe** responds that until these assets are written down, you cannot invest.

**Neil Bluhm** adds that the group's comments today almost seem more scary than yesterday. The problem is that \$3 billion of debt is rolling over every year and the banks will not be able to cover the rollover, there is no CMBS market and, while there are some programs from the government to help, it will not be enough. Some lenders may be able to extend, but at some point they will have to sell. If the banks are forced to take back these assets and sell them, it will further drive down values. No one can figure out how to deal with this massive amount of bad debt. The only saving grace that **Neil** can identify is that we always seem to find a solution.

**Bill Mack** thinks that in the next three to four years there will be a "re-equitization" of the business. It will be back to old business fundamentals, not financial engineering. But it is going to sting for a while. He is not sure that the special servicers are geared up to handle all of the required restructurings. They would rather do nothing at this point. But, there ultimately will need to be massive restructurings and dumping of properties which will drive values artificially low. Investors are waiting to see what will happen. And, while there needs to be this massive re-equitization, the pension and endowment funds are not the solution. They are smarting as well. **Bill** thinks this is a three to five year problem.

**Bruce Cohen** notes that there is a glimmer of hope since some pension funds have expressed interest in first mortgage lending. This represents much of the new capital formation going on. The CMBS market is a mess as servicers have no capacity and there is conflicts between the tranches. Ultimately, the servicers will sell this debt because the bonds have already been written down.

**Bill Mack** responds that there is a big head of steam building up and he fears that the dumping of assets will not be orderly. The servicers are paralyzed. He notes that they tried to do a 1031 exchange and it took four months to get the servicer to make a decision on a building that was triple net leased. The servicers are afraid of their own shadow. If they cannot handle a simple 1031 exchange, how are they going to handle all of this tremendous backlog.

**David O'Connor** notes that many of the banks have been busy replenishing their assets through sales of common and preferred stock. They are using some of this new capital to buy back CMBS debt. He also is hopeful that as financial institutions successfully clear their balance sheet, they will be rewarded with an increase in their stock price. This will encourage others to follow and clear their assets.

**Peter Linneman** then turns to **Steve Roth** of Vornado and asks what it will take for him to be a buyer again.

**Steve** responds by noting that there are fewer assets to buy. You can buy debt of publicly-traded companies. This was a great opportunity for a while and securities are generally trading. But nothing is really happening with hard assets. Just small one-off deals. Many of the assets are locked up in the CMBS market. The banks have not forced these loans into foreclosure.

Looking back to the 90's, **Steve** notes that from peak to peak (1988 to 2006) was almost 20 years. Kimco was bailed out by going public in the fourth quarter of '91. which bailed it out of all its problem. Simon was bailed out by going public in '93. In 1997, Vornado bought Macerich and felt they stole it. Nevertheless, it took three years to turn a profit. However, they doubled their money in 2000 and then doubled it again. Unfortunately, they have now round-tripped it all back.

When Vornado's stock was being punished, **Steve** recalls a meeting last fall with a big New York family private developer named "**Larry**". **Larry** commented to **Steve** that the public markets were not appropriately valuing Vornado. **Steve** responded to **Larry** that the public markets were accurately valuing his company. It was **Larry** and other private companies that were fooling themselves regarding the value of their real estate.

**Steve** continues, in the early 1990's, there were only a handful of public companies. Now, there are many more. This should make it easier for money to be raised. The last two years Vornado managed to pay down all of their unsecured debt, which **Steve** regards as toxic to the balance sheet of a publicly-traded company. In **Steve's** view, it is

essentially the equivalent of a personal guaranty from the company. So now they are well positioned to raise capital. Things will hopefully begin to happen a bit faster. But the fact is that the situation is not all that different than what Japan faced. We need to cleanse the banks.

**Peter Linneman** then turns to **John Kukral** and asks him when would be the right time to buy. **John** responds that it is not really a cosmic question. It will be a good time to buy when can you purchase assets at a reasonable discount to replacement value with moderate debt. So far, he has not seen this opportunity. You can only buy debt because the owners are under water. His only hope is that we will see at least one notable deal next year.

**Peter** wonders if that will be possible as long as the governments keep kicking in additional money, nationalizing banks and continuing to provide guarantees.

**John** thinks that we will begin to see factors that will force this to happen. He reminds the group that in 1991, it took until '93 or '94 for any large deals to get done.

**Neil Bluhm** thinks that it is kind of like pornography, "we'll know it when we see it." But right now, he does not see any significant buying opportunities.

**Barry Sholem** adds that with the rollover of this massive amount of debt coming due, it is hard to figure out how cheap is cheap.

**Bob Taubman** notes that replacement costs may not really be a valid measure of the correct value of assets right now.

**Bill Mack** agrees and believes that cash flow will be more important.

**Barry Sternlicht** adds that in Washington D.C., they are seeing multi-family trading at 6.6% cap rates with values at approximately 80% of replacement costs. There are people buying in this marketplace. Most of the capital is family money or other long-term patient capital.

**Steve Ross** comments that in 1991, we effectively had another nationalization of the financial sector, the savings and loans. They sold their assets at 25 cents on the dollar at first, but then these prices started to climb. At present, this is not our situation. That is why we are all worried about the Japanese scenario. However, after the S&Ls sold, the banks still had plenty of bad loans. Banks did not finally begin to start selling until much later. This time the banks have been able to raise money without selling their assets. This is not good news.

**Dan Neidich** believes this group thinks too much like real estate people. The CFO of a bank is not thinking that way. Raising capital gives him a better chance to clean up the bank's balance sheet. Unlike the '90's, there is more mark to market accounting and today, the investment banks own a lot more of these bad loans than in the past. As a result, we may see assets sooner than we think.

**Barry Sholem** says that they are looking for more capitulation. He points to IndyMac as an example of one kind of capitulation, but it is unclear whether the FDIC has an appetite to do more of these deals. **Barry's** company is a family office and while this type of money will replace some of the capital, it will not be enough. Right now it does not seem like the 90's to **Barry**. There was more talk of capitulation then. Also, unlike the 90's, there is no over-supply problem today.

**Scott Wolstein** adds that public companies with assets could swap equity for debt. He would do it in a heartbeat and does not understand why the banks are not willing to take this approach. The solution may not be to raise money and buy things at a steal.

**Hersh Klaff** notes that all these government programs have effectively "stopped the kill and left nothing to eat." This Japanese scenario that we are seeing right now will hurt the real estate industry, rather than the banking system. The private real estate groups were looking to be able to buy these assets. However, the government gave the banks what they wanted and now the banks will not sell.

**Andy Rifkin** adds that in terms of CMBS, few people realize that the bonds are still cash-flowing even though many of them have been marked to zero. As a result, the banks will not sell these bonds. Only maturity of these loans will ultimately bring some form of capitulation.

**Sam Zell** observes that in the early '90's, they were one of the largest buyers of distressed assets. They bought at \$.55 on the dollar, effectively attributing zero value to the land. In 2000, land was selling at \$100 a foot. By 2007, it was selling at \$700 a foot. Land costs were escalating at three to four times the rate of construction costs. People need to realize that land is a non-income-producing asset once a building is built on it.

**Peter Linneman** then asks the group when they think the new peak will occur starting with 2011 and going year by year. There were no "yes" votes from the group until **Peter** reached 2015 and progressively more as **Peter** called out 2016 and 2017.

**Peter Linneman** asks certain members of the group to give their final thoughts starting with **Neil Bluhm**.

**Neil** notes that the sessions have been depressing. Unlike other meetings, he just does not see any opportunities. The frightening thing to him is that we have not seen the light at the end of the tunnel on the debt problem. We may be "re-equitizing" everything, but that will not be enough.

**Barry Sternlicht** adds that this time the problem is not only with our group or the United States. Every industry and country has been impacted. It is not just about cap rates, but also declining revenue. The banks are not selling. While the rallies in the credit markets have been interesting, it will nevertheless continue to be a rough road.

Next, **Bill Mack** gives his closing comments noting that the room has universally agreed on how bad it is. The way out is complicated and uncertain. There is an expectation of slower growth, less leverage, higher taxes and more regulation, not a great picture. We need to see housing improve and unemployment leveling off. These factors will bring us back. Until then, there will be re-pricings and re-equitization of markets. Cash flow will be more important. It will be about blocking and tackling for a while. There will be a premium on quality asset management. There is a reasonable chance that money will come in and there is a higher probability that it will come back in as public equity, not private equity.

**Tom Pritzker** adds his closing comments noting that **Ken** has called this the “great recession”. Economic dislocation and broken institutions have characterized this market. The capital markets, World Trade Organization, the European Union, etc., are all broken. To address these cracks in the foundation and the lack of predictability will require a different business model.

**Steve Roth** provides his closing comments imploring the group to come to New York, eat in their restaurants, shop and go to the theatre. He jokes that since this group are all philistines he expects that they will only go to shows like Jersey Boys and Hair. But, that is okay. What is really causing him to suffer these days are ladies shoes with the red bottoms. They are coming into my house at 10 a month.

Turning serious, he is delighted to see the amount of reality being expressed in the room this year. It sounds pretty close to capitulation to him. He believes that we have been on a big leg down for some time now. The systemic risk is behind us. We will skid along the bottom and things will eventually break. He agrees with **Bruce Cohen's** observations regarding the public markets. The trading price for CMBS debt may be the best reflection of value. We need to recognize losses and get to clearing prices. These things are imminent. As a result, we need to go on the offensive, raise money and be ready with cash.

In the political arena, **Steve** believes that are seeing the greatest increase in government regulation since the Depression. After the Depression, we slowly began to reverse government regulation. We seem to go on 25 year cycles. **Steve** believes that we now have a 25 years cycle of **Obama**-like regulation ahead of us. The bashing of the banks and businesses needs to stop. However, it will continue for some time. He worries that if the current conversation does not become more constructive, we will damage the capital markets. Populism is an enemy to capitalism.

Regarding the debt markets, **Steve** thinks they will come back, but it will take some time. And no one should expect it to reach the levels we saw in 2006/2007 for another 16 to 18 years. In the meantime, more equity will be required to do deals. There also is a shift in the consumer. They are trading down. Kids in college no longer think that they will own a plane when they reach 45. He sees this as a big change in the culture. This will

impact how we invest. But, the biggest impact will be on retailers. If the consumer continues to pull back, many stores will close. Over the last five to seven years, we have grown with too many stores in the United States. B and C shopping centers will be decimated as a result. We need to keep this in mind and be careful how we invest. In the end, **Steve** feels that assets are coming, we just have to be patient.

**Peter Linneman** then gives his closing comments noting that no one could have predicted what happened in 1998 shortly before the Russian Ruble crisis, and no one predicted the tech bubble two years later, the post-9/11 bust, or in 2002, that hotels would be doing well again. And in 2005, no one predicted the heights of the first quarter of 2007. In the first quarter of 2007, no one predicted the depths of today. He notes that things typically happen a lot faster than we can see now.

**Peter** then turns to **Sam Zell** and asks **Sam** to give his closing comments.

**Sam** observes that this year there appears to be an absence of the unleashed animal alpha instinct which typically characterizes this group. He blames this on the new administration. **Obama** does not understand the correlation between risk-taking and knowing the rules of the game. He cites as an example the favoritism given the UAW over the steel workers. When the U.S. government let the steel industry decline, it was able to re-tool and become once again the most competitive in the world. Now with the auto companies, we have an unlimited obligation to prop up a failing industry. It would have been cheaper to pay all of the workers off and close the factories than paying and



keeping the factories open. In an era of more regulation, growth is dependent upon the government's ability to set clear rules. We need clarity. This is one reason why Japan was stuck in their recession for so long. **Sam** is also frightened that the administration is taking on extraordinary issues at the bottom of the cycle. Healthcare is a problem and universal healthcare would be fantastic, but no one can tell them how to pay for it. The worst thing for this country right now is to engage in class warfare. This group will be unable to make forward commitments under these circumstances. As long as we are unwilling to commit to tomorrow, there will be no tomorrow.

**Sam** thanks the group for all of their insightful comments and the reality that everybody brought to the discussion. He jokes that next year, he will not be able to read from last year's notes to demonstrate that there was a lack of reality. He thanks everybody for their candor.

With that, **Peter Linneman** closes the session and thanks everybody for their participation.

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