THE VIEW

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RESPONSE

Will the credit crunch open up new deal-making opportunities for you?

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INSIDER'S VIEWPOINT

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Keep Your Powder Dry

BY MICHAEL GOTTLIEB
CREJ Editor

It is 9 a.m. Monday morning and you're back from two weeks in a secluded villa in Tuscany or a month on a yacht in the Caribbean —whereever real estate folks go on vacation in a good year — and the first thing you do is open your trusty real estate newspaper only to discover that your world has turned upside down.

Suddenly the paradigm shift that everyone believed as gospel is no longer true. The global capital glut that was supposed to drive real estate demand from here until the end of days has turned into a drought.

At 9:02 a.m. the phone rings and it's your lender on the phone telling you that the deal you thought was locked in is no longer so. Meanwhile, your BlackBerry is buzzing so hard it is about to jump off your desk as investors keep demanding to know how you intended to hit the already stretched pro formas on the high-priced acquisition you promised would far exceed their return expectations.

This is neither the real estate bubble popping nor is it your head exploding. This is the sound of the capital bubble popping, which can be heard reverberating throughout the economy. Here's a few echoes you may have heard in the news:

- The Bank of China revealed that it holds $9.65 billion in subprime asset-backed securities and collateralized debt obligations, 3.8 percent of its total securities investments: Will all that foreign investment dry up?
- Morgan Stanley sharply cut its retail sales growth forecast for 2008 from 4.5 percent to 3 percent due to declining home values, tighter credit standards and modest job growth: Will consumer spending slow dramatically? What will happen to tenants?
- Home Depot Inc. may cut the $10.3 billion price tag on the company's proposed sale of its wholesale distribution business to private equity firms by $1 billion and still banks may not be willing to lend on the deal: Is the private equity boom over? Is there no more patient money?
- Countrywide Financial Corp. agrees to give Bank of America a 16 percent stake in the nation's No. 1 mortgage company for just $2 billion in cash: Is there any truth to rumors that Countrywide could go B.K.? Who else is at risk?

Stop. After one piece of bad news after another fanning the hysteria in the financial markets, that last bit reveals something that may keep us all out of the Hair Club for Men (or Women) a little while longer. In the middle of what one analyst called a "near-death experience" for Countrywide, BofA saw a chance for a bargain 7 percent return.

"We have plenty of liquidity," bank spokesman Robert Stickler said in media reports "and it looked like there might be chances to put it to use."

Indeed, after years of real estate players no longer asking, "Who's got the money?" and only asking, "Who has the deals?" the rapid shift in credit conditions may create new opportunities for investors for whom the market was a great market to watch. And those people who had been relegated to the sidelines are often the most interesting people to watch. I talk to a *lot* of real estate folks, but I find the most intriguing people to be those contrarian players who come out of every real estate cycle — yes, Virginia, there really is a real estate cycle — on top.

True, their success may come at the expense of those who believed that relentless capital demand was here to stay.

But if in the center of what Countrywide Chief Executive Angelo R. Mozilo described on CNBC as "one of the greatest panics I've seen in 55 years in financial services" and another level-headed investor sees an opportunity to make a good deal, then you know that there are good deals to be made. All you need to do is look past the hysteria and take a sober look at the market, practice good real estate and keep your powder dry.

It's 9:05 a.m. Welcome to the new market reality.

LETTERS and COLUMNS

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GUEST COLUMNIST

Tighter Government Controls Could Harm the Majority of Households That Benefit From a Competitive Subprime Mortgage Market

BY AARON GRUEN

News reports have highlighted the rising levels of delinquencies in the subprime mortgage market. Declining or flat housing prices, increasing interest rates and the weaker financial condition of subprime borrowers have caused significant increases in delinquency rates. In December 2006, more than 13 percent of subprime loans were delinquent. Some members of Congress and state officials have called for tougher lending standards for subprime loans and tighter controls on the interest rates lenders can charge.

The primary difference between prime and subprime mortgages relates to the risk profile of the borrowers. Lenders typically charge subprime borrowers higher rates of 200 to 300 basis points above prevailing prime rates. According to the Mortgage Bankers Association, subprime mortgages comprise about 15 percent of the total mortgage market. In 2006, the residential mortgage market totaled $10 trillion. Much of the increase in delinquencies has occurred for adjustable-rate subprime mortgages. Adjustable-rate mortgages comprise less than 7.5 percent of the total mortgage market, but comprise about 50 percent of the subprime market.

The development of a large subprime loan market has made homeownership possible for households that would not obtain mortgages in the prime lending market. The increase in homeownership made possible by subprime mortgages has especially helped minority and lower-income households.

The development of the "junk bond" market enabled companies that could not obtain "prime" loans to obtain financing, albeit at higher interest rates than "credit" companies. Similarly, households that would not otherwise obtain mortgages unless lenders were compensated for the added risks are able to live the American dream of owning housing due to the availability of subprime loans.

While the default rate on subprime housing loans is high compared with the past and the higher rate of defaults has caused the closing, sale or recapitalization of some subprime lenders, defaults on these loans are less than 4 percent. While this rate is the highest in the past five years, the majority of loans are performing and are likely to be repaid.

Subprime loans are more likely to go into default when interest rates rise and the housing market declines. Defaults on these loans hurt lenders as well as borrowers. According to a recent report, Credit Suisse Group estimates losses to investors in subprime mortgages of $26 billion to $52 billion. Deutsche Bank estimates losses could be as high as $90 billion. That subprime specialty lenders have shut down confirms that lenders as well as borrowers are negatively affected by the subprime market turmoil.

Initiatives are under way to help contain the growth of subprime mortgage defaults. For example, Freddie Mac will purchase $20 billion of loans from subprime borrowers facing increases in loan rates due to the resetting of adjustable-rate mortgages, while Fannie Mae has a created a 40-year mortgage loan product. Financial institutions, including Citibank and Bank of America, have established funds to provide subsidized loans to help borrowers avoid mortgage foreclosures.

These initiatives are better than government interfering in the subprime mortgage market by placing tighter controls on lending and limits on interest rates that can be charged to subprime borrowers when lenders have already started restricting or eliminating subprime lending. Households with high-risk profiles may decide that they are better off with high-cost mortgages. If government regulations prevent such borrowers willing to pay higher rates from voluntarily entering into loan transactions, this would prevent value-adding market transactions. Placing limits on subprime loans could prevent households with existing loans from refinancing subprime mortgages and prevent other households from obtaining loans for the purchase of housing.

Some subprime lenders have taken advantage of borrowers and should be subject to existing laws prohibiting fraud. Ample litigation will take place against lenders that committed to fraud to induce borrowers to take out subprime loans. When housing prices were rising, some borrowers expected to repay the loans from loan refinancing or the sale of the appreciated housing units. Subprime lenders expected to be protected from the costs of loan defaults by housing value appreciation The reminder that housing prices can also decline teaches or reminds lenders, borrowers and investors about risks involved with subprime loans. Government-imposed limits after the fact would be the wrong lesson to learn from the subprime mortgage turmoil. What such intervention would do is lessen the effective demand for housing and contribute to further declines in jobs in the home building, housing finance and related sectors.

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