

07.08.08

Dear Friends:

I just got back from a 2 week holiday in Italy where I was intermittently able to find the Herald Tribune and the FT in the hope of keeping up with the news. It was not a pleasant read when I did find one or both --- as the economic news seems to be worsening daily. Martin Wolf, the chief economics commentator at the FT and one of my favorite reads argues that 2 storms are buffeting the world economy: an inflationary commodity price storm and a deflationary financial one. Then today, the 8th, I picked up the NY Times where a front page story on Fannie Mae and Freddie Mac had the sub-headline: " Fears of Worse To Come". On top of that a major lender here in LA, Indy Mac, seems to be in major trouble. YIKES !! (In an earlier e-mail I wrote about the poster-child deal -- high price, low yield, high leverage, quick close -- that caused me to drop out of the market --- it was the Indy Mac HQ in Pasadena. I sure am glad I didn't win that bid !!) I think the NYT headline writer is right. It seems to me that the economic situation, especially in the financial markets, is getting worse by the day as evidenced by the continued write-downs at major financial institutions. Add on to that the rise in commodity prices -- especially oil -- and we may all be in for a challenging time. There are a lot of businesses out there that may not be able to survive \$120 +++ oil -- their economic model just doesn't work at that number.

One of the FT columnists ran a story on what you call the reverse of a "bubble". He had all sorts of cute names, but my favorite was "trubble". (Sounds like something from the famous Star Trek episode: " The Trouble with Tribbles".)

The question for us in the real estate business is how this "trubble" is going to impact us, our investments and our clients. When inflationary pressures finally force the Fed to raise interest rates cap rate increases will soon follow -- if they are not already there -- and values will fall. We are already seeing that vacancies are rising in the office and retail sectors. Both real & effective rents are dropping. Hotels are feeling the heat as people -- for a wide variety of reasons -- are travelling less. Second home projects are getting hammered as people feel the "negative wealth effect" -- people buy second homes when they are feeling flush -- which few people are these days. When you are seeing ads for "Absolute Auctions" on multi-million \$ houses in Aspen and read about the rising number of foreclosures in the Hamptons you know we have a problem. I fear that it will be a long time before that sector restarts as we first have to stop & reverse the drop in home prices (and thus

home equity) and then the economy has to build up steam again before people once again feel “wealthy”.

While a lot of news has been focused on the problems at big money center banks, there is a growing awareness of problems at smaller US banks. One report said that losses at these smaller local - regional banks were 15 times the rate of a year ago and they are being put under the regulator’s microscope. As so many of these banks were active in the residential and commercial construction business, their retrenchment, if not failure, is bound to have a real impact on the development business. On the debt side it appears that the market is still pretty much frozen with no one comfortably able to underwrite values and thus loan levels and terms. There was an excellent article in the 7/1 FT about the need to revive the packaged loan market as it was what drove the economic surge of the last decade – esp. in the real estate arena. One of the challenges is that the market is going to remain quite averse to highly complex, if not downright esoteric, loan structures, but it was those very complex packages that drove the banks profits. Simpler loan structures will not generate the high fees that the banks have gotten used to. That then ripples right thru corporate and staff compensation.

Another article that caught my attention was from the 6/26 FT which asked the question “Why the directors of big banks failed to spot credit risks”. It delved into the issue of what is the appropriate role of a board member -- macro strategist, micro risk manager, etc? When I read it I thought of how we, who run primarily private companies and sit on our firm’s Investment Committees, should define our role. I personally think the role of an IC member is to establish strategic policies and then to insure that our staffs both understand and follow those policies. The culture of most real estate firms is “to do the deal”, but sometimes the role of the IC is to put the brakes on investment activity. That’s very hard for real estate deal junkies to do. My personal view is that just as “Good friends don’t let friends drive drunk”, good investment committee members don’t let colleagues do dumb deals. When revenue is produced by putting money out this is often a serious challenge to a firm – but it doesn’t mean it shouldn’t be done. This is especially true now that most firms have staff that have never gone thru a serious downcycle – as we’ve had a great 10+ year run. I was asked recently to speak to a bunch of young, very bright investment people. They wanted to know “what was it like in 1990 when the market tanked? I suggested they also ask about 1975 or the mid 80’s. Several of them said: “but I wasn’t alive then!” So one of the important roles of IC members is to teach – using their personal experiences from past industry slumps. There is still some value in grey or no hair!

Finally, I suggest everybody read last weeks piece in the WSJ by Peter Bernstein – the risk guru. He asks “where was the risk management” in the housing collapse. He argues that the prevailing risk management strategies were managing the wrong risks. I will not try to restate his argument, but I suggest it is an important read – especially in an industry such as ours where “risk management” was, and likely still is, a pretty fuzzy concept.

As the market is somewhere between frozen and confusing, it is probably a great time to relook at your risk management policies and procedures. I suggest its also a very good time to look at your people. As a veteran of several dramatic cycles, I have found that it is in these times where the best people step up, where the people who really understand the business and its many dynamics come to the fore. These are the future leaders of your firm and the ones who best perform in these tumultuous times are the ones you want to bet on. When the up-cycle returns – as it eventually will AND there will be some terrific investment opportunities – you want to have the best talent you can find on your team.

Thanks for listening. Comments, criticisms, whatever, are always welcome. Ted