



Presents

Now What?

By Jay Rollins

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This article is a follow up to a recent market commentary, *As Good As It Gets* (see www.jcrcapital.com). In that article, we chronicled the four “legs” of the mortgage chair:

1. Commercial Real Estate Loans
2. Residential Mortgage Loans (Sub-prime)
3. Condominium Conversion Loans
4. Land Loans

In *As Good As It Gets*, we concluded that market highs for each asset class were behind us. In this article, we will look forward over the second half of 2007 and for each of the asset classes, ask: *Now What?*

Residential Sub-Prime Loans

The sub-prime fallout will continue through 2007, which means that the worst is yet to come. In the continued unraveling of “irrational exuberance” there will be two primary issues:

1. Foreclosures: Will continue and grow larger as mortgages continue to reset in 2007 and into 2008.
2. The housing market will continue to feel pain. The combination of more supply and less credit to potential buyers will continue to cause distress in housing, land and condominiums.

Forecast 2007: As sub-prime continues to unwind, there will be a domino effect on housing and land. Distressed opportunities in land and housing will emerge. For those with capital and a three year time horizon, a buying opportunity approaches.

Condominiums

The condominium market needs to be divided into two product types:

1. Condo towers under construction
2. Condo conversions (prior for rent multifamily)

For both of these types of condo projects, the “opportunity window” had closed. The only question remaining is how far the sponsor/equity/lender got through the “window” before it closed.

Condominium Towers

If the tower still has not delivered, the word is “ouch.” Sponsors and equity have no choice but to finish the tower. Many are hoping that the “pre-sales” (means different things on different projects) will be there at closing when the tower is completed.

The pre-sale dilemma includes the following:

- When were they signed?
- What is the amount of the deposit?
- Has the buyer reaffirmed his commitment?
- How do local/state treat hard deposits?
- What is the contract price versus today's price? Are they "in the money?"

Forecast: 2007: Don't count on pre-sales to bail out on new condo towers. Many of these towers will need to be restructured to multifamily or hotels. Equity and mezzanine debt in these deals will be impaired.

Condominium Conversions

The condo conversion market represents a broad array of products within one asset class. Differentiating factors for investors include:

- Destination locations
- Rental cash flow of existing tenants
- Physical asset quality
- Sub-market location
- Product finishes and amenities
- Transaction leverage

Time and patience will be virtues, and as those projects with the right mix of the above ingredients will be fine. Yet, those who "missed" on two more of the above factors are "at risk."

Forecast 2007: This will be a "quiet opportunity," but not a storm. This will be a "lender driven" event. The lenders will be pressured to reduce exposure and private lenders will start marking assets to market. Look for discounts or basis resets in the 10-30% range.

Land

Land will continue to be a different investment. Land comes in three general flavors: finished lots, approved/paper lots, and un-entitled land. The opportunities will be different for each:

Finished Lots

1. **Finished lots:** There is always a market for finished lots. This will be the first choice of distressed investors.

Forecast 2007: Opportunities will be hard to find, but will be the best investments. If you can find them at the right basis, then buy.

2. **Approved lots:** Land with all judicial approvals and votes, that land has been subdivided into "paper lots." The primary risk remaining is the development and market absorption risk.

Forecast 2007: This category will be the largest opportunity in terms of scale. There is still risk here, but this asset class holds some of the best upside for potential capital at "reset" land basis.

3. **Un-Entitled Land:** This is land yet to receive all approvals and subject to public hearings.

Forecast 2007: Forget about it. Put away the Power Points, write off the deposit. It's not going to happen – at least not in 2007.

Commercial Real Estate

Commercial real estate was the “last man standing,” but now the legs are very shaky. The market is in the midst of de-leveraging commercial assets, as mortgage investors fear sub-prime underwriting issues will spread to commercial assets. The 90% leverage used by many leveraged loan originators/wholesalers is no longer available in the market. This is wreaking havoc on originators who have loans “to be sold” on their warehouse lines. These loans cannot clear the market at the old/expected prices, and lenders are being forced to absorb losses as they write down these unsold loans. This, in turn, has caused a “market panic” that is capital based, not asset based, but real just the same. Now the leveraged lending market awaits the “new lending rules” which will develop as a result of the current market adjustments.

2007 Forecast:

- Interest rates will increase: CMBS and CDO loan spreads will widen.
- Loan proceeds will be reduced: Lenders will go back to more conventional underwriting metrics.
- Asset prices will fall: Cheap debt has kept asset prices artificially high. This will slowly end, as cap rates rise.

Conclusion

For the remainder of 2007, those with patient capital and a wide origination network will have a unique buying and financing opportunity. This will not be the melt-down of circa 1992-1995, but for those who were waiting for “something to happen,” your time has come.

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JCR Capital customizes each transaction to fit the client's needs, which may include; pricing, proceeds, structure, flexibility and speed.

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| <u>Financial Products</u> | <u>Asset Classes</u> | |
| • Bridge Loans | • Office | • Land |
| o Value added – some cash flow | • Multifamily | • Land Development |
| o Opportunistic – no cash flow | • Retail | • Condominium |
| o Special situations/fast closings | • Industrial | • Affordable Multifamily |
| • Mezzanine Loans | | |
| • Equity | <u>Geography</u> | |
| o Small balance: \$1-5 Million | • United States | |
| o Large balance: Over \$ Million | • Baja Mexico | |

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