LONGWAVE GROUP

IAN GORDON ECONOMIC FORECASTER & INTERPRETER OF THE KONDRATIEFF CYCLE

Those who cannot remember the past are condemned to repeat it. Santayana

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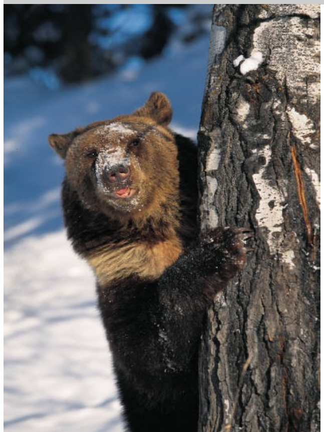
WINTER WARNING



Mauled by the Malls

During 2008, with well known retailers like Circuit City and Linens 'n Things filing for bankruptcy protection, and retail vacancies at U.S. malls and shopping centers approaching a 10-year high; several Wall Street research analysts predicted as many as 12,000 retail stores would close during 2009. As the global depression deepened, it soon became quite evident that many U.S. commercial real estate enterprises were besought with mounting financial troubles, elevating concerns that the commercial market may experience its own subprime-like mortgage debacle. Indeed, after a 7-month unsuccessful effort to refinance $27.3 billion (U.S.) of maturing mortgage debt, Chicago-based General Growth Properties, the owner of more than 200 U.S. malls, filed for bankruptcy protection last month. General Growth is America's second largest shopping mall owner, from Westlake Center in Seattle, Washington, to Faneuil Hall in Boston, totaling over 180 million square feet of retail space which includes over 24,000 retail stores nationwide. This is a capital intensive business and the company had embraced an aggressive acquisition strategy, heavily funded by debt. Much of General Growth's debt load can be traced to its $11.3 billion (U.S.) purchase of commercial property developer Rouse Co. of Columbia, Maryland, in 2004.

Since then, a soaring U.S. unemployment rate (currently 8.9%) and declining retail sales have combined to negatively impact the cash flow of retailers across the malls and shopping centers of America. A recent report by New York City-based real estate research firm Reis reveals that store vacancy rates at U.S. malls rose by 9.5% in the 1st. quarter, eclipsing the 8.9% vacancy rate recorded for all of 2008. Reis' director of research, Victor Calanog, reports that *"U.S. consumers are worried about their asset bases, since their home values and retirement accounts are still reeling; they remain concerned about future income as job losses accelerate".* Within the U.S. commercial real estate industry, there are concerns that other commercial real estate operators who are in the same boat as General Growth. The largest U.S. mall owner, Indianapolis-based Simon Property Group, lost 435,000 square feet of retail space to bankruptcies last year through September 30th. compared to a loss of 50,000 square feet in the same period a year earlier. Last November, CEO David Simon commented that the company's multi-year leases protect the company to some extent from monthly changes in consumer spending. Undoubtedly, that remains to be seen! Rounding out the top five U.S. mall owners are Developers Diversified Realty of Beachwood, Ohio; Kimco Realty of New Hyde Park, New York and New York City-based Centro Properties Group. According to Reis, it's only going to get worse for retailers, since the researcher expects mall vacancies to exceed historical levels through 2011, before they stabilize sometime in 2012. Mr. Calanog notes that *"commercial real estate usually shows a lag based upon jobs growth, as in the last down cycle, commercial rents didn't turn positive until 18 months after jobs started to grow. Any turnaround for retail centers is also incredibly contingent upon the thawing of the credit market."* We are more than inclined to agree!

To add insult to injury for creditors, when General Growth applied for bankruptcy protection, it included 166 of its malls in its restructuring application. The company borrowed money via *"special purpose entities (SPEs)"* which were thought attractive by lenders because SPEs were deemed by legal opinions to be *"bankruptcy remote,"* meaning their cash flows were dedicated to debt servicing. However, in papers filed last Wednesday in

a U.S. bankruptcy court in New York, General Growth argued that the CMBS investors' objections to the inclusion of the 166 SPEs *"appear grounded in the misperception that 'bankruptcy remote' means 'bankruptcy proof."* Is there no decency left in this life?

Commercial Mortgage-Backed Securities (CMBS)

Basically, commercial mortgage-backed securities are packaged products of bond issues secured by income producing entities ranging from automobile loans and shopping center mortgages, to credit card loans and student loans. Over the past 20 years, the $700 billion (U.S.) CMBS market has evolved into the major source of financing for commercial real estate projects in America and General Growth has emerged as its single largest borrower. According to a document recently viewed by the Wall Street Journal, federal regulators examining the 19 largest U.S. banks are projecting losses of up to 12% on commercial real estate loans over the next two years. Correspondingly, as mall vacancies rise and rental payments decline, loans made by many small and medium-sized U.S. banks to commercial property owners and developers, not only risk default, but also, the solvency of the banks themselves. This 12% assumed loss rate implies that America's banks and thrift institutions, which hold $1.8 trillion (U.S.) of commercial real estate loans on their books, would incur a staggering $216 billion (U.S.) in losses by the end of next year. Surely, if that were to unfold in the coming months, any remaining doubt in the minds of economists and analysts about the U.S. economy being in a state of depression, would be erased.

Recently, Moody's Investors Service downgraded $52.9 billion (U.S.) of collateralized debt obligations (CDOs) which are securitized by American commercial real estate debt. The rating agency also noted that the performance of a number of CMBS deals in Europe, the Middle East and Africa had deteriorated in the last quarter of 2008. Moreover, Moody's stated that it expects *"the performance of CMBS loans to deteriorate further and negative rating actions to increase significantly."* Furthermore, Fitch Ratings recently warned that deteriorating CMBS loan credit quality is creating downward pressure on ratings and was uncertain whether loans could be refinanced when they matured. About 41% of all Fitch's publicly rated European CMBS bond issues, secured against pools of commercial real estate mortgages, are at risk of potential rating cuts. Euan Gatfield, a senior director at Fitch, notes that *"some of the largest CMBS loans in Europe will mature in the next 2 – 4 years and it remains questionable whether markets will have improved enough by then to allow for orderly refinancing."* Standard & Poors recently said that it may soon cut the rating on more than 700 American CMBS issues.

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