

Public Private Investment Funds: Feeding the Addiction

Upon the Government's announcement of the proposed Public-Private Investment Programs the market surged nearly 10%. Once the program was reviewed and intended effects more thoroughly explored, this sudden exuberance faded. We believe the extension of leverage to induce private capital and compress bid/ask spreads may result in the unintended consequences of ineffectual price discovery at best or subsidized speculation with tax-payer dollars at worst.

Speculators Anonymous

Step 1. Admit you are powerless to Leverage. The US Real Estate market is in the grips of a housing hangover after a decade long binge fueled by securitization, exotic mortgages, lax underwriting and cheap credit. The frivolity in financing propelled home values almost 200% during the 10 years ended December 2006. In comparison inflation averaged a mere 2.5% for the same period. This disproportionate growth was the driving force behind consumer spending and the ultimate expansion of GDP and the economic markets.

While the housing market enriched personal wealth, it also became the core profit center for banks and the greater financial services industry. Unlike the traditional banking model where mortgages were made with the purpose to collect a spread over the cost of deposits, mortgages were now mechanisms to generate fees. Banks collected fees for originating, pooling, tranching, servicing and selling mortgages. Structured financing facilitated the increased complexity involved throughout this process and led to the eventual introduction of leverage. As mortgage pools became more homogenous and credit spreads compressed, financing became a fixture to generate the requisite yields. Mortgages were sliced and packaged in derivative securities, which were swiftly blessed with AAA ratings, and then became portfolio holdings for institutions of all types.

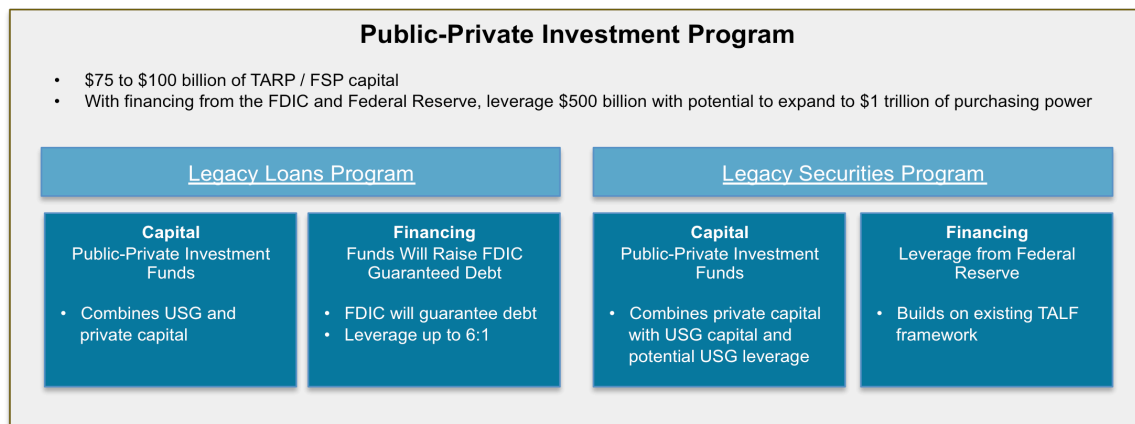
By 2006 the first vintage of ARMs began to reset in a rising interest rate environment. Delinquencies developed into defaults and by 2007 the housing market sprint had come to a crawl. With the absence of credit, prices started to retreat. The subsequent asset deflation deteriorated home values by an average of 30%, contracted US personal wealth by \$6 trillion and triggered a credit contagion as the capital reserves of the banks collapsed under their investments collateralized by defaulting mortgages and mortgage related securities.

Peter, Meet Paul

The Resolution Trust Company (RTC) was formed with the intent of resolving the ails of the banks arising from the Savings & Loans Crisis. At that time, the capital adequacy of the banks was impaired initially by their portfolios of junk bonds and the lack of liquidity that ensued after forced dispositions. Similarly, recent changes including mark-to-market accounting, the elimination of Freddie Mac and Fannie Mae preferred shares, and unmitigated leverage have resulted in write-downs at financial institutions leaving many at the precipice of insolvency. Despite the effective nationalization of the banking system and an extended period of deleveraging, lending facilities remain gridlocked and capital markets constrained.

The current price instability will continue to persist until markets have been fully delevered or new capital is introduced to the system. In the absence of capital, liquidity - defined as the ability to execute transactions with minimal price impact - will remain elusive and preclude any true price discovery.

In an attempt to stabilize the markets the Federal Government has announced the establishment of the "Legacy Security Program" and "Legacy Loan Program". Both are chartered to purchase assets from the banks and recapitalize illiquid holdings. Modeled on the public-private partnerships of RTC, the programs seek to induce private capital through the extension of Federally guaranteed financing.





The programs are designed to allow the market to ascertain the economic value of “legacy” assets and compress the extensive bid/ask spread that currently persists. Essentially, the premise of these programs is to replace *private* leverage with *public* leverage under the auspice that the government has a preferential funding rate and indefinite holding period. While the consequence of inaction extends the vicious spiral of price declines, the reintroduction of leverage opens the possibility of artificially supporting inflated values and transferring risks from the private sector to the public taxpayer.

The Legacy Security Program defines “securities” as the CMBS, RMBS & CDO instruments collateralized by real estate and rated as AAA at time of issuance. By definition, the program’s selection process narrowed the set of qualified managers to 5, presumably PIMCO, Blackrock, Legg Mason and 2 others. Each manager will be required to raise \$500 million in private investment funds, which will be afforded considerable federal financing to purchase securities from the banks.

Legacy “loans” by contrast are the performing and non-performing mortgages and notes held directly by the banks. Eligible institutions will submit pools of loans that they wish to offer for competitive auction. The FDIC and selected advisors will review the portfolio, ascribe an initial valuation range and determine the level of leverage the pool will support.

Upon successful auction and bank acceptance, the manager will create and establish operating agreements for an investment partnership to manage the assets. Equity investments will be made *pari passu* by the partnership and US Treasury, with debt issued and guaranteed by the FDIC at a maximum ratio of 6 to 1.

After our initial review of the nascent program details provided by the Government and based on Sequoia’s experience in investing in distressed real estate through similar auctions, the following observations keep our optimism in check.

Participants: While the “Legacy Securities Program” has been effectively limited to a select group institutional investors, the “Legacy Loan Program” is open to a broad spectrum of “Qualified Investors” who *represent* they are capable of managing a portfolio of loans and property. The natural propensity of many investors to “trade paper” as opposed to manage real estate may encourage over aggressive bidding and then stress absorption rates and prices in the underlying properties as they hit the market.

Affiliated Firms: Insured banks and thrifts (including any subsidiary, affiliate or related entity in which they have a financial interest) that are allowed to participate in a public-private partnership present an inherent conflict of interest that has yet to be addressed in the program. Furthermore, non-recourse financing may facilitate aggressive bidding that would directly or indirectly benefit the holdings of an impaired bank while transferring the financial risk to Federal government.

Voluntary Participation: The ability of the banks to issue select portfolios and reject submitted bids will likely fail to quickly close the current bid/offer spread and will require multiple iterations by participating firms. These investors will be hard pressed to expend the resources to fully underwrite portfolios knowing that the loans may not trade. With the prospect of several thousand auctions, participating firms will greatly discount bids to account for the risks of non-transaction and the high costs of due diligence.

Subordinated Position: The prospect of permanent funding mitigates much of the participating firms duration risk. However, the first loss position of the investor coupled with leverage may limit price discovery. A preponderance of the loans submitted will be troubled and/or construction loans, which may not support debt service and may also have negative cash flow. Furthermore, the risk/reward profile for these assets are significantly different than performing loan pools.

As seen in the days following the programs announcement, the market responded with concern to both programs. Comments submitted to the FDIC question the integrity of the auctions themselves. Our sentiments echo those concerns and participation will largely be based on the clarity of the programs. The collective definition of success would incorporate a significant recovery of the capital at risk. Conversely, some might consider just recovery a success.

Note: This document is prepared by and is property of Sequoia Debt Ventures and is circulated for informational and educational purposes only. There is no consideration given to the specific investment needs, objectives or tolerances of any of the recipients. Recipients should consult their own advisors, including tax advisors, before making any investment decision. This report is not an offer to sell or the solicitation of an offer to buy the securities or other instruments mentioned. Sequoia Debt Ventures research is based primarily upon proprietary analysis of current public information from sources that Sequoia Debt Ventures considers reliable, but it does not assume responsibility for the accuracy of the data. The views expressed herein are solely those of Sequoia Debt Ventures as of the date of this report and are subject to change without notice. The views represent Sequoia Debt Ventures’ outright views in these specific markets, but not all markets that Sequoia Debt Ventures trades. Sequoia Debt Ventures may have a significant financial interest in one or more of the positions and/or securities or derivatives discussed. Those responsible for preparing this report receive compensation based upon various factors, including, among other things, the quality of their work and firm revenues.