

THE CASEY REPORT

Investing Ahead of the Crowd

Volume I, Issue 3/September 2008

Real Problems for Real Estate

Dear Readers,

Owning a home ranks right up there with baseball and apple pie as a part of the American dream, a dream that has increasingly been adopted (without the baseball and apple pie) right across an increasingly interconnected world.

It was little wonder, therefore, that when given every incentive to join the ranks of the homeowners, people jumped right to it.

And, in the process, created what is very likely the largest economic bubble in history. Summing up the situation, *The Economist* put it well.

“...the total value of residential property in developed economies rose by more than \$30 trillion over the past five years, to over \$70 trillion, an increase equivalent to 100% of those countries’ combined GDPs. The surge not only dwarfs any previous house-price boom, it is larger than the global stockmarket bubble in the late 1990s (an increase over five years of 80% of GDP) or America’s stockmarket bubble in the late 1920s (55% of GDP). In other words, it looks like the biggest bubble in history. ...”

Of course, the implications of this bubble extend well beyond a straightforward calculation of house values. Like a supernova, the number of satellite industries sucked into the swirling vortex of the \$30 trillion bubble is breathtaking in its scope.

The easy-to-identify satellites include the mortgage originators, hundreds of which have shut their doors... the banks, hundreds of which may yet shut their doors... the major financial institutions... the bond insurers... bond buyers... home builders... real estate brokers... appliance manufacturers... home improvement stores... even the people that provide the proverbial kitchen sink... and the list goes on.

“What’s going on now in the residential real estate market is much like the tech bubble, but potentially much, much more serious than what went on in stocks a few years ago.”

And the list of economic dislocations isn’t limited to housing-related businesses. All manner of enterprises cropped up, or were beefed up, based on the financially empowering sense of new wealth felt by homeowners after surveying the ballooning (paper) value of their own green acres.

Manufacturers of cars and all manner of consumer goods, here and around the world... home equity lenders and credit card companies that facilitated the con-

version of paper equity into tangible goods... even governments at all levels, spoiled by the higher tax collections which are now rapidly devolving into unfunded liabilities... they were all caught up in the bubble-mania.

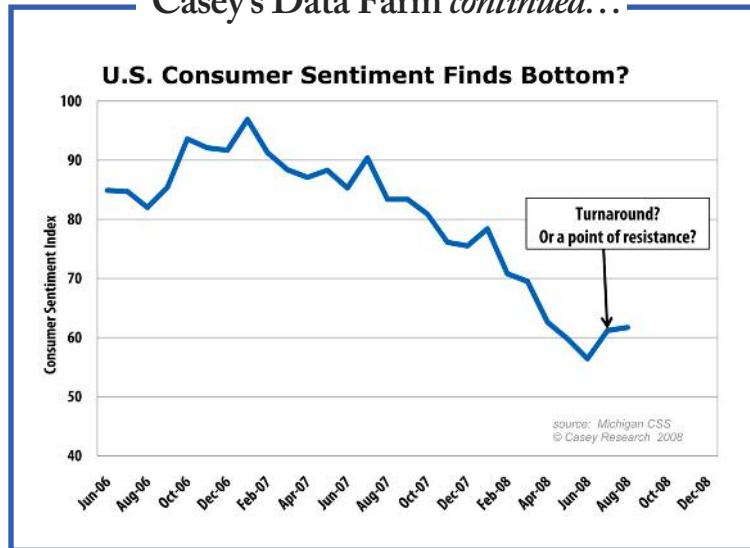
That the bubble had grown to historic, and unsustainable, proportions was, in the hindsight of most, easy to see. If they had only bothered to look.

[Ed. Note: To blow our own horn, we did look... steadily warning about the real estate bubble all the way back to early 2004. Including this, written by Doug Casey in the *International Speculator* back in August 2005, right as the bubble began to peak... “What’s going on now in the residential real estate market is much like the tech bubble, but potentially much, much more serious than what went on in stocks a few years ago.”]

What made the bubble obvious was that, over the five-year period during the biggest part of the bubble expansion, U.S. household income was largely flat, increasing about 3.9% on an annualized basis.

And the money chasing house prices ever higher wasn’t coming out of savings, which were largely stagnant through the 2005 real estate peak.

So, where did the \$30 trillion come from? The quick answer is easy credit... and lots of it.



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Special Feature

Periodically we will bring you special features on topics of particular importance or interest.

Real Estate Insights by David Galland

It was only after considerable cajoling that **Andy Miller**, a consummate real estate entrepreneur and longtime acquaintance of Doug Casey's, reluctantly agreed to speak at our March 2008 Casey Research Summit held in Scottsdale, Arizona. His reticence, as was later explained, came from concerns he had about how the audience would react to his rather dim views on the outlook of real estate.

You see, despite making his bread and butter from large real estate projects and related activities, Andy had previously tried warning colleagues and professional groups that the sector was headed for big trouble. Fed up with criticism from his peers that he was being too pessimistic, Andy eschewed public forums and acted on his own analysis by liquidating much of his holdings.

To make a long story short, in Scottsdale Andy delivered what I think most

participants would agree was the most insightful, interesting, and valuable presentation of the event. Which, given the stellar line-up of speakers, is saying something.

Following the event, Andy commented that he was, in hindsight, happy he had accepted our invitation — because of the overall level of intelligence of the audience and because of the warm response he received. He enjoyed it so much, in fact, that I was able to convince him to take some more time away from his far-flung business affairs to sit for an interview for this special real estate edition of **The Casey Report**.

Who Is Andy Miller and Why You Should Pay Close Attention to What He Has to Say

As for the specifics of his business, following graduation from the University of Denver with an accounting degree,



Andy Miller

Andy worked as a CPA for Coopers & Lybrand.

In 1980, he joined with four other partners as Loup-Miller Development Company, which designed and developed shopping

centers, apartment communities, office buildings and warehouses across the United States, including in the cities of Tampa, Orlando, New Orleans, Dallas, Chicago, Phoenix, Tucson, Albuquerque, and Denver.

After the real estate debacle of the 1980s, Andy co-founded SevoMiller, Inc. in 1990. The company provided workout services for major financial institutions throughout the country and also began buying and developing apartments, retail and office properties. From

its founding to the present, the company's acquisitions totaled over 30,000 apartment units, several million square feet of retail space, and numerous office projects throughout the country, including the states of Colorado, Arizona, California, Nevada, Illinois, Texas, Louisiana, Indiana, Oklahoma, Georgia, and Florida.

Employing over 500 people, SevoMiller also built, managed, marketed, leased, and sold commercial real estate for many institutions and third-party owners across the country. Clients included General Electric Credit, SunAmerica, and Huntington Bank, as well as many defunct banks, savings and loans, and private equity groups.

In 1994, Andy and Dave Frishman co-founded Realty Funding Group, a mortgage and finance company that has acted as a mortgage broker and mortgage banker for numerous commercial real estate projects across the U.S. RFG has provided financing for over \$1 billion dollars of commercial real estate. In 1998, Andy founded Rapid Funding, a commercial and residential hard-money lender that has loaned in excess of \$200 million for land developments, shopping centers, office buildings, and construction loans on condominium buildings. In addition to sourcing and servicing real estate loans, Rapid Funding also handled its own workouts and sales.

Each of these companies founded or co-founded by Andy now operates as part of the Miller Frishman Group.

So, when I used the term "consummate real estate entrepreneur" earlier, I wasn't being flippant... Andy is a serious, big-project professional with deep experience in real estate from the ground up, including the intricacies of financing the buying and selling of same.

Given the importance of the outlook for real estate to the outlook for the U.S., and by extension, even the global economy, you need to know what Andy knows about the outlook for real estate.

Our interview follows...

TCR: The residential real estate bubble has been deflating for some time now. To use something of a cliché, what inning in the ball game do you think we are currently in for residential real estate nationally?

Miller: Starting with the big picture, the residential market is going to get worse, and the reason that I say that so confidently is because of an issue I briefly touched on in Scottsdale. Namely that money is now being withdrawn from the mortgage markets. It's important, for your readers especially, to understand that the boom in residential housing was fueled in large part by the bond market.

"... the federal government, no matter how much they want to, cannot fuel the mortgage markets for all of America. It can't be done. The numbers are way too big."

Simply, what happened was that financing became easy and so, the entire boom was based and predicated on easy money and being able to land mortgages cheaply and easily. But, clearly, those days are gone. Worse, however, is that there is now a lot of incentive for private money to get out of the mortgage markets. Why? Obviously, there are the losses and the diminution in value. But there is another, far more subtle reason to exit the mortgage market — and that is that all fifty states are passing legislation to protect borrowers and to penalize lenders.

And they are not alone. The federal government has passed similar legislation, and I expect more laws to follow. To

name just one consequence, it is now very difficult for lenders to foreclose. And in many states, the burden of proof is on you to prove that you are not a predatory lender. So, lenders must prove they didn't do something untoward when they originated the loan. If things don't work out, and you can't prove you didn't do something wrong, the lender is culpable and the penalties extreme. In some cases, your entire loan balance could be discharged. As a result, lenders are getting out of the mortgage business in droves.

The situation is especially acute in the commercial market, which I'll talk about in a minute. But sticking to residential for the time being, my thesis is very simple: the federal government, no matter how much they want to, cannot fuel the mortgage markets for all of America. It can't be done. The numbers are way too big. Fannie Mae and Freddie Mac already account for almost 50% of the loan production in America, and I think it is clear to everybody that Fannie and Freddie are probably no longer going to function in the way they have in the past. Maybe there will be a government bailout, and maybe there will be what I predicted in Scottsdale, that sometime next year, they will just be extensions of the United States Treasury. The Treasury will want to have much more input into the mortgage market because it is a natural extension, in their minds, of monetary policy.

At any rate, whether I am right or wrong, it doesn't make any difference. Can you imagine a world where the federal government is the most instrumental player in the U.S. mortgage market? If you think that's okay, just head down to the Department of Motor Vehicles office closest to you and tell me how that experience is.

In any event, Freddie and Fannie have been gutted, and they are not doing the kind of production they need to in order to help clean up the situation, even

though they have raised their loan limits. While I don't have a statistic to back this up, it's my view that a huge percentage of the production going on right now in the mortgage market is FHA production. That is not going to cover places like California, or New York, or Florida, or Phoenix, Arizona, or Las Vegas, because the FHA loan limits are low, and you have a whole world out there of residential borrowers that exceed those loan limits.

So, we are in a situation right now where a lot of private money has vacated the markets and more wants to vacate. In fact, a private money supplier would have to be crazy to say "Hey, let's take a big allocation and go into the residential mortgage markets." That's because you would be loaning right into the jaws of a declining-value environment and a deteriorating regulatory environment. So, I think the regulatory environment is going to exacerbate this problem in a big way.

The bottom line is that there is no mortgage money available, or limited mortgage money available, to do what people were used to doing, which will only exacerbate what I think will be further substantial declines in house values.

In 1992, 51% of Americans owned their own homes. Today, that number is just under 70%. So, there has been a huge increment of homeownership added to the United States economy, and there is no way for those homeowners on the bubble, who relied on high Loan-to-Value (LTV) loans with low interest rates, to buy their own homes. So people are giving them back.

In fact, I have noticed that the stigma of foreclosure and walking away from a home is lessening. Something else we see a lot of these days is that people are walking away from their homes and preserving their credit cards; just the opposite of the way it used to be when people would sacrifice everything to keep their homes. Today, it is just the opposite. A

huge percentage of borrowers out there see the hopelessness of hanging on to a home that is declining in value, and they walk away, but they can't move without their credit cards, so they save that. So, this is a real problem. It's a mess, and it's going to get a lot worse, and I don't see much on the horizon that is going to be a relief.

"... the federal government, no matter how much they want to, cannot fuel the mortgage markets for all of America. It can't be done. The numbers are way too big."

TCR: To use something of a cliché, if this were a baseball game, what inning do you think the housing meltdown is in?

Miller: Third or fourth inning probably. Keep in mind, David, that there are still somewhere around a trillion dollars of rate adjustments that have to be addressed for residential borrowers in America. That is almost certainly going to exacerbate the problem. It's also worth keeping in mind that the average American homeowner moves once every six and a half years or so, and there is no money available right now. If you want to sell your house, it is very difficult to do. You know, a lot of these contracts that used to close automatically are now falling out. The condo world is very difficult. The housing world is difficult, and I expect this decline to continue.

TCR: The last number I saw on the topic had the inventory of single family homes at about four million homes. Some analysts think that the inventory is going to have to fall by about 50% before

prices stabilize. Is that in sync with your view of things?

Miller: Well, I look at it differently. While that would certainly help, you first have to answer the question, what is going to bring the inventory down?

The only thing that could make me feel more positive would be to see an infusion of private money into the mortgage markets. As long as you see private money staying away, this is going to stay a huge problem. That's because there can't be a turnaround until there is a new supply of mortgage money, and I don't mean government mortgage money. That's not going to work. I think you have to see the bond market get reinvigorated. I think you have to see private lenders get excited again about putting money back into the mortgage markets, and we have to see the dynamics change to the point where people feel good about the regulatory environment. Until private money gets back into the mortgage markets, things will continue to erode.

TCR: I know Treasury Secretary Paulson has been talking about covered bonds as being one possible solution. What are your thoughts?

Miller: How would that solve the underlying problems?

TCR: I guess it depends on what the basis of the underlying value in the bonds is. If they are footed on anything close to current real estate values, I imagine they would be a nonstarter.

Miller: Not only that, I think that still begs the question, "What do you do when a homeowner goes into default?" The reason the mortgage market has functioned very well over the last 50 or 60 years was that you could rely on the rule of law. If a borrower stopped paying, you knew that, at least, you were going to be able to foreclose and still have a piece of real property that you could turn

around and resell. That is not the assumption anymore.

Anecdotally, last year I had to foreclose on 11 residential properties in New Jersey. The foreclosure was uncontested. The borrower never answered one pleading. The borrower never showed up at one hearing. The borrower did not take a bankruptcy, and it still took me 26 months to get title to the properties. As bad, in that 26-month period, there were a dozen break-ins to these properties during which the copper piping and appliances were stolen, as well as a tremendous amount of damage caused. Well, that's what lenders are experiencing right now all over the country. So, I think that, you know, all these solutions are interesting, but what the government doesn't get — and I meet with government officials all the time — is that as long as you're penalizing lenders, as long as you're making it difficult and unpleasant to foreclose and for lenders to pursue remedies, you won't have a stable mortgage market. And if you don't have a stable mortgage market, you're going to have falling home prices. Period.

TCR: Have you heard anything out of the government, out of any branch of the government, that's made any sense to you in terms of a bailout at this point, or is it all just destructive?

Miller: All really destructive. I am sure they have the best of intentions, but you know the road to hell is paved with good intentions, and all these good intentions also have unintended consequences. And so, they pass laws to protect borrowers, but when you pass laws to protect borrowers, the odds are good you're doing something that is going to hurt lenders. And when you're hurting lenders, they'll withdraw money out of the market, which makes it very difficult for borrowers to get new financing, and whenever new financing is available, David, it's not available at the high LTVs that it was before.

To name one example, as I understand it, Minnesota now makes it very difficult to produce new adjustable rate mortgages in that state. Well, what of borrowers who already have adjustable rate mortgages with a very high LTV loan and with a loss leader interest rate? Now that they can't go back to an adjustable rate mortgage, it's devastating.

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As long as the government stays involved with this, they're going to interfere with the market, they're going to interfere with private money, and that's the only way out of this. No matter what we think, the U.S. Government cannot accommodate all the mortgages in America; it's not possible.

TCR: I'm reminded of your comments in Scottsdale that if the government stayed out of the mess, the downturn might be several years, I think was the number you used. But if they got involved, it'd be a decade or more.

Miller: The government being involved with this will definitely extend the problem. There's just no question about it. They will do what happened in Japan. By trying to ease the pain of some of these losses, it's going to make the problem much more protracted, and you can feel it already.

Conversely, if the government got out of

the way and left the free market alone, yes, it'd hurt. It would be very painful. I believe we'd go into a serious, serious recession that would be really bad for a while, and then it would get better. The reality of the situation is that the only way to work out of this is for people to take losses where there'd be a substantial amount of pain. Only then can things begin to return to some sort of balance. That can't happen if government doesn't let the markets work.

TCR: We're of the opinion that Obama will win this November, after which the Democrats are expected to control both the White House and Congress. So, it's hard for me to envision a scenario where the government is just going to step aside and turn its collective backs on the borrowers. So, based on your view, in that scenario, this thing could drag on for many, many years and, perhaps, we could even see a systematic collapse.

Miller: I believe that scenario is entirely likely. The government doesn't show any signs of letting this problem unfold on its own — in fact, just the opposite. Whether Obama is elected or McCain is elected, either one, I think it's probably a given right now that we'll have a Democrat House of Representatives and a Democrat Senate and, maybe even a veto-proof Senate at that. While we can't know how it will turn out for sure, if we see those kind of dynamics at play, yes, there's going to be a lot of involvement of the government in the markets, and that means it's going to take a long time to wash through the system.

TCR: Can you think of a historical comparison to the situation today? From the data we've seen and some of Shiller's stuff, it appears that this is the biggest bubble in history. Is there anything that has come before that we can use as sort of a comparable?

Miller: No, there is nothing. Not even

the Great Depression was like this. Earlier I quoted a stat that 51% of America owned their homes in 1992, and today that number has ballooned to the point where it's just under 70%. I believe we've just lived through the greatest expansion of capital in the history of planet Earth, in the history of mankind.

And this happened really all over about 12 or 13 years, this gigantic, dynamic expansion of money. And as we all know now, the money predominantly went into housing and asset-backed finance. There is no precedent for this. One truth about cycles is that the downward part of the cycle is usually quicker and more painful than the upward swing. We didn't get into this thing overnight. It took many years, and we are not going to get out of it overnight. It's going to take many years to unwind.

TCR: Do you have a general sense of how much further house prices could fall?

Miller: It's very geographically dependent. There are some cities that are relatively okay, like Austin, Texas, where prices are actually still increasing. Albeit modestly. Then you've got disaster areas like Las Vegas, Phoenix, Miami, and some places in Southern California. So, it's very geographically dependent. I will tell you that in the bad markets such as Phoenix and Las Vegas, there's almost certainly quite a way to go, potentially a huge drop from here. I don't think it would be unreasonable to expect another 20% or 30% drop in those markets. The rest of America — it really depends on the supply, the demand, what's going on in terms of the level of house prices, because obviously the lower-level housing is much easier to finance today than the higher-level housing.

And let me just mention another point about the current situation that readers should find very interesting as it has huge ramifications. It has to do with the jumbo market, which is defined as prop-

erties that exceed Fannie's and Freddie's loan limits and so are ineligible for financing from those organizations. Because of the exodus of private money, the jumbo world is without any liquidity. Certain areas, even entire states such as California and New York, are almost entirely jumbo markets.

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In any event, previously for a loan to avoid being considered a jumbo, it had to be under \$417,000, though the limit has been increased recently in places like Southern California and other problem areas around the country.

The problem is that there are a lot of places where people have been taking advantage of appreciating home prices over the last 15 years by trading up, and people have steadily sold their homes, bought bigger and nicer homes, more expensive homes.

Well, today, if you're looking for a loan over \$600,000 or \$700,000, in most areas of the country it's very, very difficult to obtain financing. People with lower-priced homes, where they may have received 100% financing, are really just sort of glorified renters. They didn't

have any equity in the home, they didn't put much cash into the homes, so when they lose it, is the lender going to feel pain? Of course. But the impact on the liquidity of the borrower who put nothing down will be minimal. They didn't have any to begin with, they don't have any now, and they didn't invest anything — they didn't lose any equity.

Whereas in the jumbo world, it's different. There's real equity there, there's real money in these houses, and it's going to be lost.

TCR: Earlier, you touched on Freddie and Fannie. What's your outlook for those entities?

Miller: Well, Freddie and Fannie are, for all intents and purposes, insolvent. This is something I have been talking about for the last year, and now they're broke. They're going to have huge losses. So, the question becomes, what happens to them, and my prediction is, of course, that the Treasury will either recapitalize them and supervise them, or supervise them, or whatever they're gonna create here to come up with a palliative to make this better. But I think what you can bank on is that there's going to be a lot of transition here and that whatever production Fannie and Freddie are doing is going to go down.

That bodes very poorly for recovery. So Fannie and Freddie are toast, and the only question now is how will they recapitalize, and who will help them recapitalize. I think the government has been telegraphing here for the last 30 days that the shareholders are going to lose all their money. So we'll see a situation where they both have to go out to the markets to raise new liquidity, but while they are trying to do that, the Treasury will be saying, essentially, “Oh, by the way, if these things fail, you guys are going to lose all your money.” Who's going to want to come in with more money under that scenario? Nobody.

Either way, Fannie and Freddie are, I think, going to become less and less significant in terms of loan production, and we need loan production if we hope to solve this crisis. I know that many in the U.S. Government, and particularly a lot of the members of the Senate and the House of Representatives, are pinning a lot of very high hopes on Fannie and Freddie solving this crisis, which just shows how ignorant they are about how the markets work. Fannie and Freddie cannot solve this crisis, and, in fact, Fannie and Freddie being impaired right now and having the prospect of somehow being supervised or taken over by the U.S. Government just means that the production will get slower and slower and they'll be less and less productive entities. So, that's going to exacerbate what's already a very serious problem.

TCR: It seems like there would be a market opportunity here for a lender who had some cash and stuck to tight lending policies. There are going to be a lot of people looking for loans, but if the nation's lending mechanisms are shutting down, then somebody who'd be willing to step up and make loans would seem to be pretty well positioned.

Miller: Ah, but David, let's suppose you're a lender that feels that way and you want to go back into the markets now, and you want to take advantage of what you're seeing, which is, you know, very little liquidity in the markets. The problem is the regulatory environment has scared you. That said, I see a huge opportunity in the jumbo market.

TCR: Right.

Miller: In fact, I've toyed with the idea of loading up with a lot of money to be deployed in very geographically specific areas where there is a shortage in jumbo mortgages. But I can't justify doing that with a regulatory risk right now.

All you have to do is screw up one document, or fail to be complete in one dis-

closure, or have a borrower who is a particularly sad case. Or got sick or got divorced, and you may lose your loan, or you may be impeded from collecting your money for many, many, many years.

“There used to be a mortgage broker at every corner, but today they're all going out of business in mass.”

TCR: Given the size of the mortgages involved, you are talking about real money.

Miller: Exactly. So why would a private person who has a profit motive want to embroil themselves in all of these regulatory complications. I can tell you they don't, and that's why you're seeing a thinning of the herd right now. There used to be a mortgage broker at every corner, but today they're all going out of business in mass.

Which is why the only production going on right now is Fannie, Freddie, and FHA — that's it. There's no other big production going on that amounts to much.

TCR: I remember hearing Barney Frank (chairman of the House Financial Services Committee) on an NPR show, and he was talking about the FHA, which up to that point had been very tight with its standards and therefore hadn't run into as much trouble. Frank was positively apoplectic about it, saying things like, “We're the federal government, damn it, and we should be making loans!” It was really quite stunning, because he was saying in no uncertain terms that the FHA should be pursuing the same reckless lending that got Fannie and Freddie and everybody else in so much trouble.

When you look at Frank's biography, it's a glaring fact that his entire career has been in government with absolutely no practical business experience whatsoever.

Miller: He is one of the most destructive forces in the mortgage market now. I can tell you from my world, that every time he starts spouting off and giving these kind of lectures and talks and prescribing fixes for the market, he scares the mortgage market, the private people, the ones that really matter. He scares them to death, and any thoughts that anybody had about entering the mortgage market, after they listen to Barney Frank, they quickly have other thoughts.

TCR: Let's turn to the topic of commercial real estate. You had warned again in Scottsdale last March that the commercial sector was headed for trouble. Reading the news lately, it appears your call was spot on. Can you update us on your views?

Miller: There is no way to talk about the commercial real estate market without being specific, because as I outlined in Scottsdale, the commercial market isn't some homogeneous thing. It's broken down by product types, and they all function differently.

So let me start with retail shopping centers, which probably, in my mind now, are the most exposed product type, and I can tell you that, generally speaking — and it may not apply to some properties and may not even apply in some cities — but nationally as a whole, I think that retail cap rates have eroded somewhere around 100 basis points.

TCR: Can you quickly describe cap rates for our readers?

Miller: Sure. If I were to buy a shopping center for \$10 million and, after I subtract the expenses from the gross income, I'm left with a million dollars, that's a 10% cap rate.

So operating income is 10% of the purchase price. So obviously, in an appreciating real estate market, cap rates, generally speaking, will move down because buyers will pay more for less (cap rates, that is). Conversely, in a falling market, cap rates will rise.

TCR: Okay.

Miller: And so, what we're seeing right now is that shopping center evaluations have probably eroded by 100 basis points in cap rate, which is a huge number. So, for example, we have a grocery-anchored shopping center in Phoenix that's about 94% occupied. We've been trying to sell it for the last nine months. We've had it under contract probably four times. Each time, it's fallen through because the buyers were unable to find a lender. When I was talking in the residential market about a lack of liquidity, it's particularly acute in the commercial markets. The overwhelming amount of commercial mortgages that were written over the last 10 years for most product types, except apartments, were done by conduits, and they were done by asset-backed finance securitizations, CDOs, etc. The overwhelming number of those conduits are now either out of the market or shut down.

As a consequence, say, you have a shopping center that you financed three years ago through a conduit with an 80% loan to value, and you have to refinance that loan today. For starters, you'll likely be looking at a lower property value and, secondly, you're going to have to accept a lower loan to value. That's because lenders have now lowered their standards to 70% loan to value, so it's very punitive right now. All of which means that if your loan matures, you're going to have to dig into your pocket to get a new loan or to renew your loan in order to re-balance it.

Let's take some real numbers just for illustration, because this is how the commercial market works. Let's say, in that same example, I bought a shopping cen-

ter for \$10 million and it has a million-dollar net operating income, or a 10% cap rate — and cap rates today are probably 7%.

But for simplicity, let's say we have a 10% cap rate. Well, let's say that I went out and bought that center three years ago and I put an \$8 million loan on it and we put \$2 million in cash and today my loan is either adjusting or it's maturing and I've gotta go find new financing.

“The overwhelming amount of commercial mortgages that were written over the last 10 years for most product types, except apartments, were done by conduits, and they were done by asset-backed finance securitizations, CDOs, etc. The overwhelming number of those conduits are now either out of the market or shut down.”

Today, that same shopping center may be a 12 cap or an 11 cap, and so let me just give you some real numbers — with a million-dollar net operating income, if cap rates moved from 10 to 11, that shopping center today is now worth only 9 million dollars.

You just lost a million dollars, and now your loan comes due. If a lender is willing to loan you only 70% of the value on that \$9 million, that means your loan amount will be \$6.3 million versus your old loan amount of about \$8 million. Maybe you paid the principal down a little bit, but not much, so you now need to

come out of pocket for \$1.7 million just to do a new financing.

Well, that's not going to happen. So, there's going to be a tremendous upheaval in the commercial market relative to the fact that there's almost no conduit money available anymore.

And so, that falls to all the life insurance companies, pension funds, and endowment groups and their private equity funds to be able to fill in the gap, but they can't. The numbers are too staggeringly large. Life insurance companies only want triple-A projects with triple-A sponsors. By comparison, before the crash, the financings by conduits, with very high LTVs and very low coverage, were available to pretty much everybody.

So that is something that the market is trying to come to grips with right now, yet most people I speak to are not even aware of it.

The government oversight people that I've talked to were not aware of this, most underwriters are not aware of this. Certainly, the lawmakers are not aware of this at all, and I don't even think lenders are aware of it yet, David.

TCR: Hasn't commercial held up fairly well versus residential?

Miller: You haven't seen any dramatic spikes in delinquencies, you haven't seen any huge problems statistically come out of the commercial market, but I'm telling you that it's wobbling right now. We see every sector wobbling. Shopping centers I started with, 70s and 80s quality apartments are really wobbling right now. Even though occupancies are strong throughout the country, your net rental revenue isn't strong. You're still getting huge concessions, and people are moving out very quickly. There is huge turnover in these apartments, so they've gone down in cap rate.

TCR: So if you owned a shopping center that wasn't considered a triple-A property and you were trying to sell it, would you be able to find a loan?

Miller: It's very difficult. You can find a loan, but because you're not a triple-A property and because you're not a triple-A sponsor, the loan you find may be a 50% or 45% loan to value.

So the numbers just get more acute, and you might be able to borrow in a commercial bank, but the number has to be low enough... and let me also mention to you, this is really a shocking thing to me; again, I don't think this is very, very visible to the market places right now... but commercial banks are completely locked up now.

They are not loaning any money. And the money that they are loaning is just slam-dunk kind of stuff, just no-brainer. But they're not doing anything that they were doing a year, a year and a half ago — nothing. And the conduits are going. So all of this money supply is gone.

TCR: Why haven't we heard more about this problem so far?

Miller: It's like when you shut off a hose at the spigot, and it still runs for a little bit on the other end. It takes about six or nine months, I believe, for the effect to be felt in the commercial real estate market. For example, the banks have all shut off credit right now, so let's say you're a dry cleaners in one of my shopping centers. You used to be able to go get a fixture loan, you used to be able to go get an accounts receivable loan. Some retailers were working off inventory loans. You can't find a financing anymore, and I'm now seeing the biggest casualties in the Ma-and-Pa retail businesses that I've seen since I've been in business.

TCR: Recently I drove for about three hours in upstate New York, and the number of the small shopping centers

and condominium projects that were just boarded up was very noticeable. There were also a large number of hotels and restaurants boarded up. It was quite eye opening.

Miller: Sticking to just the retail for a moment, we're seeing a very large attrition right now, a very large attrition in small, local tenants.

For example, in Denver, we have way too many restaurants. Well, that's going to shake itself out. I think we have way too much retail generally in the United States. There's been a big retail boom. Obviously, consumer spending is over 70% of our GDP. The American consumer is responsible for 18% of the GDP on planet Earth.

“Housing and apartments move in lockstep, and it makes sense; as the price of housing goes down, obviously rents and apartment costs have to go down.”

So, obviously consumer spending drops as energy prices go up, food prices go up. Even if they go down a little bit, the fact that, over the last 10 years, a large part of consumer spending was fueled by low interest rates and by the ease people had being able to refinance their homes, consumer spending is going to come under pressure. Everything has changed now.

And so, there's no question you are going to see a pretty substantial diminution in consumer spending, which is going to really translate into pain for retail.

TCR: What about other commercial sectors?

Miller: Apartments, I think, are going to continue to be painful despite the general impression people have in this country that as housing erodes, apartments get better.

That's completely wrong. Housing and apartments move in lockstep, and it makes sense; as the price of housing goes down, obviously rents and apartment costs have to go down.

We see people that have been foreclosed out of their homes, while they may move into an apartment for a period of time, what they're really trying to do is go rent another single-family home. So that four-million inventory that you cited earlier, that's all available on the rental pool, and, in fact, I know several groups around the country that are buying single-family homes just to rent them.

TCR: What about office space?

Miller: The office market, of course, is eroding. Cap rates have gone down in office. They've eroded. Obviously you can use your common sense to know that every office building had a mortgage company, every office building had a title company, every office building had someone in the trades, an electrician or a contractor — those guys are all vacating their offices in mass.

While I expect the central business districts around the 20 top cities in the country to probably be relatively stable in terms of office occupancy, I think the suburban markets are going to get creamed.

TCR: What about other sectors?

Miller: Warehouses are bad. They're very flat. Users are consolidating; they're not expanding. And the condo world I've talked about in Scottsdale is going to implode.

There are way too many condos. There is no way that people are going to be able to buy those. Most condo owners... now, again, you haven't seen much about this in the press, and in fact, even some of the biggest lenders are still pretty bullish on the condo market. Corus Bank of Chicago, for example, which has a huge amount of their book of business booked in condos. That's maybe one of the greatest shorts I've ever seen.

I'd also be wary of hotels. The hotel business is proliferating right now, in a way that I've never seen. There are so many new hotels being built right now nationally that there's no way, even in good times, that I think they could sustain occupancy.

TCR: Were all these hotels already in the pipeline? Is that why they are still being built?

Miller: Some of it, but a lot of these hotels now have created new flags and they're putting them in multiple locations in most big cities. So there's been a tremendous proliferation of hotels and, with high air fares and high gas costs, there's no question that that's going to be a bad place to be.

TCR: Taken together, the commercial sector comes in at just under \$4 trillion, if I'm not mistaken.

Miller: There is some debate about the size. I've heard various numbers from \$4 to \$6.5 trillion, but it's a big number, David.

TCR: It's a big number. So, as, commercial real estate starts to slide, we can expect both risk and opportunities. What's your thinking on, say, shorting REITs?

Miller: I think many REITs are going to go down in value, particularly some of the REITs that are exposed with inferior grade of product, inferior locations, and there are many of them. The prob-

lem with shorting REITs is this: you not only have to be right about the short, but you have to be right about when it happens, and that's what I'm queasy about, because the one thing about government involvement in the market place is that they can skew things for short periods of time. So I think it's a very risky play just because it's very hard to predict right now what the timing is going to be to see this stuff unfold. Having said that, I do think there are natural things to short. For example, there are a lot of the heavy construction outfits out there that have relied on a lot of building and construction over the last 10 years that are probably going to get hurt worse and sooner.

“...when I see the market really turn, I'm going to buy the highest-quality assets I can as cheap as I can buy them, because I think those assets will be the first things to turn.”

TCR: Haven't they already been hit pretty hard, though?

Miller: Some of them have, but some of them are still pretty high. Some of them are still in a good place. For example, there's EMCOR, ticker symbol “EME.”

I'm not sure if it's appropriate for you to print this. I don't want to cause the company any problems, but that's a textbook case of the sort of company that might be shorted, and I think over the next 6 to 9 months, you can make a lot of money on your short, because half their business is maintenance and the other half is construction, and the half that's construction is going to go way down.

There are a lot of plays like that, but I'm always very careful about shorting because when you're in an environment where the government is going to get involved, it can skew things against you.

TCR: Always worth remembering. Switching gears, how will we recognize that the bottom for real estate has actually arrived?

Miller: That's a great question, and I have a good answer for you, and it's probably a unique answer. I will be able to tell you pretty precisely when the market is at the bottom, and the way I'll know is when I see private mortgage providers getting back into the housing market. At that point, I'm going to start buying everything I can possibly buy.

TCR: By extension, then, another indicator we could watch would be if, after things getting sufficiently bad, we start seeing legislation coming through that actually supports private mortgage lending.

Miller: And I would start really gobbling things up, but I would still be very fussy about where I gobbled things up. For example, I would stay completely out of the state of Michigan, because their government is such a mess. So, when I see the market really turn, I'm going to buy the highest-quality assets I can as cheap as I can buy them, because I think those assets will be the first things to turn.

TCR: So beachfront land will be something to look at?

Miller: Possibly, but I mean, for example, if I were going to enter housing, I'd probably buy mid-priced homes. Meaning, I'd buy things between \$600,000 and \$800,000, where you know you're going to see a big supply of money when the markets get friendly again.

And I'd buy very well-located shopping

centers, very well-located office product, very well-located and usable warehouse product.

TCR: I know that just before the Great Depression, there was a big spike in property prices. During the depression, those prices fell and then stayed pretty flat for about 20 years. So, in terms of an opportunity, would the smart move, once things turn around, be to buy commercial properties at a low price for the income that they throw off?

Miller: I can tell you that there'll be a big disparity between properties that are throwing off money and properties that aren't. And that's going to be the dividing line. I think a big opportunity may be buying properties very cheap that aren't throwing off income and trying to figure out a way to make them throw off income. That's what we do around here.

TCR: Can you explain?

Miller: We just started something that is very rare. It's called a commercial special servicer. A loan servicer is someone, after your loan is made, who collects your payment, divides the interest in principal, accounts for the loan, makes sure you have an impound for taxes and insurance, makes sure that the taxes and insurance are paid, etc., etc. When a loan goes into default, the servicer no longer handles it. The file is given to what they call a special servicer, and it's the special servicer's job to foreclose, or do a workout, or recast the loan, or do whatever — usually to foreclose, you know, try to fix up the property, make it saleable. They hire real estate brokers, they hire leasing agents, etc.

TCR: Got it. So your new company provides that sort of service for troubled commercial projects?

Miller: Yes. Our new company, Johnson Capital/Miller Frishman is essentially a one-stop shop for defaulted paper. So if you're a bank, if you're a pri-

vate equity group, and you have a package of mortgages or you have a bunch of mortgages that have gone into default, it's really hard to find special servicers. It's easy to find residential special servicing. There are a lot of them across the country, but there are very few commercial special servicers, and we just started that entity here in expectation of a huge amount of product having the need for that kind of service in the country.

“I think a big opportunity may be buying properties very cheap that aren't throwing off income and trying to figure out a way to make them throw off income.”

TCR: Sounds like you are going to see a lot of opportunity. Is there anybody else already doing it that people could look into in terms of investing?

Miller: Not that I know of. I mean, there's some people who do things that are close, but I think that unique thing that we offer here is, we offer a one-stop shop. We offer everything — property management, loan services, property sales, leasing. We offer construction. If someone has a partially completed office building, we can finish it up, we can lease it, we manage it, we can put a loan on it when it's time, we can sell it, and that's very unique to find in the country right now. It's very hard to find that kind of service. Most special servicers, what they do is that they just do the special servicing. They go out, they hire a property manager, they hire an investment sales person. We do all that in-house, and so that's what makes it unique.

TCR: All of which proves the point that, if you look at things from the right

perspective, you can always find opportunities... even in bad times. On the topic of opportunity, in terms of the longer-term view, do you think there is any chance that this market could bounce back sharply?

Miller: In the commercial market, you can't answer that generically. In the residential market, it's hard to call because my view is, of course, that everything emanates from the supply of mortgage money. Could you see a bounce? Sure, you could see a huge bounce if there's an unrestricted supply of mortgage money going into the mortgage markets and if it was big, if all of a sudden the government turned around and provided encouragement for private investors to go in the mortgage market and to do it in a big way, I think you could see a huge bounce.

TCR: But you're not very optimistic on that front.

Miller: No. I don't expect that to be the case. I think we have to see how things work out over the next 12 to 24 months, and then I think we have to take a step back and see, and gauge what we see, and try to figure out what's going on in the market, what the government's doing, what the private marketplace is doing, and try to understand, you know, where we are on the curve.

TCR: Is there a publication that a retail investor with an interest in keeping closely in touch with real estate might want to subscribe to or read?

Miller: On a national level, I will tell you that, for commercial real estate, most of the brokerage houses like CBRE Commercial (www.cbre.com) and Marcus & Millichap (www.marcusmillichap.com), which have national publications. It's not for the entire country but maybe the top 20 cities in the country. They publish vacancy rates, and rental rates, and supply-and-demand projections for most of those markets in every product type.

And those are probably the best gauge, even though I don't find them to be terribly reliable in terms of the future; but those are probably the best publications that are out there right now to really understand what's happening dynamically in the market. But there is no substitute, and the thing that I caution people all the time is, if you're interested in getting into the real estate business in any sort of way that's substantial, there is no substitute for actually talking to people in the marketplace who are both property owners, developers, real estate people, just to get your own pulse of the market and understand, because within a market that's bad, there may be pockets that aren't bad.

All of these markets are unique. They all function in a little bit different way, and it's really hard to approach this in a generic sort of fashion.

TCR: As we come to a close, and we really appreciate you taking so much time with us, let me ask you about the bigger picture on the economy. Real estate is such a huge part of the U.S. economy, and by extension therefore the world economy, as bad as you think things are going to get in real estate, what do you think the implications are for the broader economy?

Miller: I think things are going to be very bad. I think what we're seeing is a lot of people in America having to come to grips with a lot of things right now. You can't refinance your home, you're paying a lot more for energy, you're paying a great deal more for food, your savings rate is negative, you have a record quantity of debt on both your

house and in the rest of your household, including on your credit cards and your college debt.

“So, I think 12 to 24 months from today, we’re going to be in a severe contraction mode. There’s going to be a lot of pain, and I just recommend — and this isn’t a very sexy recommendation — but I recommend that people stay out of the real estate markets until we see something positive happen.”

It's all converging, David, to one point in time here, which is going to make it very rough. So, I think 12 to 24 months from today, we're going to be in a severe contraction mode. There's going to be a lot of pain, and I just recommend — and this isn't a very sexy recommendation — but I recommend that people stay out of the real estate markets until we see something positive happen. And I recommend that, as much as possible, people should stay out of debt and, as much as possible, be very, very conservative with their investments.

TCR: Interest rates are obviously very important in the bigger picture. Do you

see them going up or down?

Miller: I'll answer by talking about Treasuries, because to me that's the most significant rate we can talk about. I don't know what the feds are going to do, whether they'll go up or down, who knows? But I believe two things: one is that the 10-year Treasury yield is going to bounce around. I think you're going to see it go down and then ultimately, I think the 10-year Treasury has to go way up. The reason I say that is because the Treasury has already told us that they're going to finance all these recapitalizations that they have. They're going to do that by selling 10-year Treasuries. So I expect a huge supply of 10-year Treasuries, and so, while 10-year Treasury yields will probably go down, probably for the next 6 to 12 months, I then expect them to get very high.

And I think that the yield curve is going to get very steep, and I think you may see short rates go down or stay where they are while long rates eventually go up, but that's not imminent. I think, first and foremost, the powers-that-be up there are going to engineer it so that, you know, at all cost you can keep rates down for the short term.

TCR: Okay. Thanks again for taking the time. Personally, I have a whole new understanding of what's going on behind the scenes.

Miller: My pleasure, David, I hope it helped.

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How to Invest in Andy Miller's Viewpoint

In Andy Miller's eye-opening interview, he mentions two potential short candidates, **Corus Bankshares Inc.**, a Chicago-based bank with considerable portfolio exposure to the condo market; and **EMCOR, Inc.**, a maintenance and construction company. For your reference, the basic stock charts for those two companies are shown here. Before taking action, keep in mind Andy Miller's cautionary comments on the risks inherent in shorting a stock... especially in a regulatory environment as fluid as it is just now.

Another Way to "Short" the Real Estate Market

An alternative way to play a falling real estate market is offered by the **ProShares UltraShort Real Estate Fund (NYSE:SRS)**. The goal of this ProShares fund is to return twice (200%) the inverse of the daily performance of the *Dow Jones U.S. Real Estate Index*.

The *Dow Jones US Real Estate Index* is composed of companies involved in the development, management or ownership of shopping malls, apartment buildings and housing developments... and in real estate investment trusts (REITs) that invest in apartments, office and retail properties. As you can see from the chart here, the ProShares UltraShort Real Estate Fund has largely fulfilled its mandate as U.S. real estate has ratcheted down over the last year and a half.

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