and killed a pedestrian in Santa Fe last week. The apparently intoxicated driver left the scene. David Axelrod, a senior adviser to Obama, told *Fox News Sunday* that news of Richardson's nomination might be premature.

Finally, it is worth mentioning the Obama administration's formation of an "Economic Recovery Advisory Board" headed by former Fed Chairman Paul Volcker. The day before Thanksgiving, Obama took the opportunity to promise Americans that "help is on the way." Volcker's sober influence is welcome.

## The Conclusion – So Far

While we can take some comfort in the actions taken so far by Team Obama, many of which provide evidence of pragmatism and constraint, there is no question the new administration has a lot of bills due and payable to Obama's many avid supporters, a sizable portion of which appear to have unrealistic expectations. An obviously extreme but illustrative example of those expectations is provided by the much-viewed video of the exuberant Obama supporter Peggy Joseph following Obama's acceptance speech, who exclaimed: "I won't have to worry about putting gas in my car. I won't have to worry about paying my mortgage. If I help him, he's going to help me."

*Don Grove is our Washington, D.C. correspondent. Don casts a jaundiced eye upon the activities of Congress, the White House, and the courts from his front row seat in the nation's capital where he is an attorney in federal practice and a managing partner in his law firm. Don entered the practice of law from a background in engineering and heavy industry, including the manufacture of trucks for municipal fleets and the design and prototype field testing of rough-terrain tractors in Australia, as well as researching and drafting patent applications and lobbying Parliament. He graduated summa cum laude with a BS in International Business from the University of Maryland and cum laude from American University's Washington College of Law where he served on the editorial board of the Administrative Law Review and represented clients before the IRS as a student attorney. He clerked for the Reporter of Decisions at the United States Tax Court in Washington, D.C. and worked on Capitol Hill for Senator Bill Frist and for Congressman Bob Clement. He served on the board of directors of U.S. China Educational Ventures and as a language instructor for that organization in China's interior. He served as a law clerk for the chief judge of the United States Court of Federal Claims, where plaintiffs bring high-dollar lawsuits against the United States, such as the savings and loan and spent-nuclear-fuel cases. He is admitted to practice in Maryland, Washington, D.C., and Tennessee and is admitted to the bar of the U.S. Court of Federal Claims, the U.S. Court of Appeals for the Federal Circuit, the U.S. District Court for the District of Columbia, and the U.S. Supreme Court. Don is a champion of limited government in the belly of the beast.*

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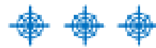

# Special Feature: Update on Real Estate – A Follow-up Interview with Andy Miller

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

*In our September edition, we provide a lengthy and very valuable interview with real estate pro Andy Miller. Given the importance of real estate in any discussion of the current financial crisis and because there have been so many developments since our last interview, on your behalf I imposed myself on Andy once again to get his updated views.*

*For those of you new to the service, it is important to know something about Andy Miller's career, in order to gauge just how much he knows about the topic at hand.*

*Following graduation from the University of Denver with an accounting degree, 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.*

*With that introduction, here is my interview.*

*David*

**TCR:** The last time we spoke, at the end of August, you were quite pessimistic on the outlook for real estate. Paraphrasing your view at the time, you were concerned that if the U.S. government continued to meddle with real estate markets, they would chase away the few remaining private lenders and prolong the pain, maybe by years.

A lot of water has flowed under the bridge since our last talk, with the government initially signaling it was going to buy toxic mortgage paper, but now saying it won't be taking that route, but rather injecting money directly into the banks.

What's your general take on the developments of the last few months and where things stand now?

**Miller:** There is much to say about recent developments because I think they rank up there with some of the biggest events in American history, on a par with the Civil War and the Great Depression.

Let's start with the residential markets, then move on to what's going on with commercial real estate.

> **" I think you're going to see continued weakness in housing, particularly in some parts of the country. This erosion in home equity has implications such as those we have already seen for consumer spending, and that's going to get worse."**

As I predicted would happen at the Casey Research Scottsdale conference last March, and again in my August interview, home values have continued to erode and, most alarming, probably 90% of the entire lending market in the country now emanates from the government-sponsored entities of Fannie, Freddie, and the FHA. And the few private lenders still operating are, by and large, just selling their paper off to Fannie and Freddie. Unless it is jumbo paper, then there's almost no one doing any loans unless they are very low loan-to-value loans, like 45% to 55%, maybe even 60%.

That the government is effectively doing the vast majority of the lending in the country is a very bad harbinger of things to come. The mortgage market in America is estimated to be somewhere between $11 and $13 trillion. That's an awfully big number for a government to be administering – and I don't think they can handle it.

So for all intents and purposes, the residential market has been impacted, not just in terms of falling values but also in the underlying structure of lending mechanisms, and that bodes very poorly for the future.

As a result, I think you're going to see continued weakness in housing, particularly in some parts of the country. This erosion in home equity has implications such as those we have already seen for consumer spending, and that's going to get worse.

So, the residential market is a mess, and the government doesn't show any signs of being realistic at all about solving the mess. Christopher Dodd and Barney Frank are still talking about stopping foreclosures, and they have enacted a $300 billion FHA program targeted specifically to people with poor credit. To participate, I think you have to have at least a 90% loan-to-value and you have to be at least three months behind in your mortgage payment, which is absurd.

As I have previously predicted, when the government begins monkeying with the marketplace by changing rules based on some political expediency, it only makes things worse. For example, when the government tries to stanch foreclosures by encouraging bankruptcy judges to cram down the principal on loans so people can stay in their homes, they will only serve to further scare the bond markets, which until recently had been the provider of all capital for the mortgage market. And, of course, further decimate the remaining private lenders. Put another way, why would I, as a private lender, want to loan any money into the mortgage market if I know that I can't foreclose? Or if I know that my $250,000 loan could wind up getting crammed down to $150,000 by a bankruptcy court judge? You may argue that this would cause mortgage rates to increase, but mortgages are constrained by federal and state laws.

Why would I want to take those kinds of risks – especially when government regulations cap the interest rate I can

earn? Those regulations mean a lender can't ask for 25% interest on a loan, even though the risk might justify a 25% interest rate.

And so the government meddling in the home market has not only spurred a lot of the problems, but I think it's going to make it much more intense in the months and probably the years to come.

**TCR:** There has been a lot of talk about JPMorgan and other banks doing workouts with the people who couldn't afford their mortgages or were not keeping up with their mortgages. Does that approach have any merit in terms of a broader solution?

**Miller:** Well, it has merit in keeping some people in their homes, but it also has unintended consequences. For example, let's say we take Household A and Household B and they live next door to each other, and they live in the exactly the same-priced homes, and say they each cost $300,000.

Household A has problems. They extended themselves too much. They have too much debt. They have been irresponsible in their finances and in how they live their lives, and so now they have gone into default on their loan and "Poof! Voila!" whether it's JPMorgan, or Fannie and Freddie, or some fiat by the U.S. government — all of a sudden they get a workout and they get favorable treatment on their loan.

And now you have Household B – they've been responsible. They haven't taken on too much debt. They have tried to live their lives appropriately, and they're still paying the freight, which is a hardship for them. It's still a hardship for Household B, but they've managed to eke it out and do the appropriate things. But, when they learn about the sweet deal offered Household A, why are they going to continue to labor to make their mortgage payments? The answer is that many won't. That is just one of the unintended consequences of these bailouts. This encourages bad behavior.

Even with the workouts, however, a lot of people are just throwing in the towel, thinking that even with a workout, it's a hardship for them to maintain a mortgage payment, and they just want to give the house back. As an aside, these days many homeowners are okay with walking away from their mortgages, but they keep current with their credit card bills. That's just the reverse of the '80s when we saw people wanting to keep their homes and get rid of their credit cards.

> **"A lot of people were just really glorified renters. If they made a down payment, it wasn't much, so what kind of ownership is that?"**

Many of the buyers during the housing bubble have discovered that homeownership is too much of a hardship. Even though you may reduce the interest rate on the mortgages, the houses still need new roofs, or a new furnace, or other forms of maintenance – and many people just don't have the financial means to handle those costs right now. And so, rather than suffer all these continuing hardships, it's just easier to walk away from the home, and that's what's happening now and that's what I think is going to continue to happen.

**TCR:** Right. Owning a house and taking care of the costs, even without the mortgage, takes a lot of money.

**Miller:** Yes, and you must believe the houses are going up in value in order to justify that. And I don't think anybody does, particularly in the most troubled spots in the country now, and there are a lot of them. So that's a big problem.

**TCR:** This goes back to something you said when we last spoke, that the number of new homeowners has soared since the late 1990s, thanks to the bubble. As a result, aren't a lot of people in houses who shouldn't be?

**Miller:** A lot of people were just really glorified renters. If they made a down payment, it wasn't much, so what kind of ownership is that? There is no real equity in many of those homes. And even though many of those homes were purchased many years ago, equity has been withdrawn through refinancing. In my opinion, that's the case with at least 20% of the Americans that bought homes since 1992.

**TCR:** So, there is a lot of housing inventory that's going to come back on the market, which means prices for retail housing are going to remain under pressure. What's the situation on the commercial real estate side?

**Miller:** As I told you in our last interview, we have started a commercial servicing operation, which is called Johnson Capital Special Servicing. As a result, we have had occasion to meet with a large number of the lenders in the country that have produced and are sitting on commercial mortgages.

As a way of describing the prevailing industry view, I might share an observation made over dinner the other night by the head of a major American life insurance company. He said that it feels like he is watching a slow-motion car wreck. That he's sitting behind the wheel and there's just not a thing he can do about it. I think that's really pretty much the consensus on the part of all of us that are involved in the commercial real estate world. We are literally watching cap rates erode in every product type right now. Whether it's apartments, shopping centers, office buildings, industrial properties, hotels, senior housing — operating incomes are eroding. Cap rates are eroding. Operating expenses are going up.

It's a real problem now, but it has not

reached a crisis level yet. By the third or fourth quarter of next year, though, I believe that it probably will.

There is something your readers should understand about the commercial real estate market that makes it significantly different from the residential market.

To set the context, it's worth noting that it's not nearly as large as the residential sector. The commercial sector is probably a $3 trillion problem instead of, say, an $11-13 trillion problem.

Even so, it's very acute in a lot of ways. First of all, there is a big difference in the commercial, versus the residential, CDOs. I don't know if most of your readers are familiar with CDOs [collateralized debt obligations], but if you don't mind, I'd like to take just a moment to explain them so everyone can understand the full gravity of what's going to unfold here.

**TCR:** Absolutely.

**Miller:** We've had the experience of CDOs unraveling on the residential side. We have not had the experience of it yet on the commercial side, and the commercial side is going to be interesting.

CDOs were created when financial institutions aggregated huge amounts of mortgages, either residential or commercial, into a pool. They were always homogeneous. In other words, residential and commercial mortgages were never intermixed in a pool.

As with the residential, the commercial loans would be packaged and then stripped out in a seniority system into bonds, and the CDOs were created with that sort of structure. But there's a stark contrast between the commercial CDO world and the residential CDO world. The residential world is principally made up of all these home mortgages, and when a handful of home mortgages default, it doesn't have any significant impact on the CDO. Of course, if lots of mortgages default, which has been the case of late, then it has a great impact. By contrast, in the commercial world, the properties are fewer and much bigger. For example, you may have ten properties in a commercial pool that ultimately works its way into CDOs. Those loans are huge. You may have a shopping center loan in there for $25 million and an office building loan for $30 million dollars. As a result, if you have a default on just one of those loans, you can effectually wipe out all of the subordinate tranches.

**"…it's completely topsy-turvy what we're doing right now. It used to be the United States was founded on savings and on investment, but today, really, unless we have consumer spending, we are in terrible shape, and that's what's coming."**

And that is why when you see the problems begin to appear on the commercial front, it's going to be a much quicker sort of devolution than we saw on the residential side.

**TCR:** If the commercial market is $3 trillion, do you have any idea of the total size of the CDOs that were footed on that amount?

**Miller:** No, I don't, but it's appreciable, and it's very large and it's very disturbing, and the lenders that are out there are expecting the worst. The lenders that are on the front lines with this recognize how much value has been diminished. They recognize how difficult this is going to be to get out of, and they're expecting things to get much more serious than anything they've ever experienced before. Even so, I still think that they're underestimating what they're going to see in terms of the severity of these losses. This will be exacerbated by the lack of any liquidity or replacement financing.

**TCR:** So, potentially, well over 3 trillion dollars?

**Miller:** One of the things we learned from the residential market is that, as bad as the losses from the properties and the CDOs and the residential mortgage-backed securities were, there were ramifications to lots of other sectors of the economy and investment markets. And the same is true in the commercial CDO world. It's going to have other ramifications, and by property type, I can tell you that shopping centers are weakening now appreciably. Suburban office buildings are going to erode in value. Industrial is suffering. I think multifamily apartments that were built in the '70s and '80s are suffering and will continue to suffer more. I think hotels are very weak right now. Senior housing is weak right now. You can just go up and down the line and it's problematic.

**TCR:** From our perspective, while we've seen big hits in the stock market, the real bad news in terms of the economy is still yet to come. Would you agree with that view?

**Miller:** Yes, because remember that consumer spending had grown to the point where it amounted to something like 72% of GDP. While that has already started to fall, things will begin to fall in earnest next year; it's going to go way down. I can tell you that many of my retail tenants are just waiting until the Christmas season is over and then they're going to close up shop.

As we see attrition in consumer spending dollars, it will be devastating for the economy, which is why the government is talking about a new stimulus package and giving everybody some more money so they can go spend it. I mean, it's com-

pletely topsy-turvy what we're doing right now. It used to be the United States was founded on savings and on investment, but today, really, unless we have consumer spending, we are in terrible shape, and that's what's coming. I don't think that there's any amount of stimulus in the world that will psychologically provide a catalyst for people to go out there and spend like they did. In addition, the days of refinancing your home and withdrawing the equity are gone.

And that brings me to the TARP program, and that's pretty interesting because the TARP program is ill-conceived. It accomplishes one thing and that is that it optically made the banks' balance sheets look better. It alleviated the immediate pressure for the banks to have to go raise capital. That's all it did, and I guess there's some argument to be made for why that's a good thing and that it helped to preserve the infrastructure of the financial system in the United States.

However, as to the purported purpose of the TARP program, to somehow restimulate the banks' appetite to lend money is a boondoggle. In order to save the overleveraged situation that we've got right now, if that were your goal, which obviously it is for the U.S. Congress — in order to not realize all these huge losses, you'd have to entice banks and other lenders to go out there and make the same stupid loans that they were making before. Otherwise, you don't solve the problem. People have too much leverage, whether it's in commercial real estate, whether it's in corporate debt, it doesn't matter, you pick the venue. It's the same everywhere you go. There is too much leverage.

So what is it that's going to entice lenders to go out again and loan too much money — I don't think it's going to happen. And so, I think the deleveraging is going to intensify. I think this is going to get much more acute, and I don't think it matters what the government does. I think you can throw another trillion dollars at this and it won't make any difference. The market is going to deleverage now, whether you want to or not.

**"I noticed something about the '80s that I notice again today, even though the dynamics of the two problems are different and I expect the two problems to unfold differently. But there is an element of the problems then and now that's very interesting to me, relative to human nature, and that's the state of denial."**

In the late '80s, we went through a big displacement in commercial and residential real estate, and it was bad. I noticed something about the '80s that I notice again today, even though the dynamics of the two problems are different and I expect the two problems to unfold differently. But there is an element of the problems then and now that's very interesting to me, relative to human nature, and that's the state of denial.

In the '80s, I noticed there was a massive state of denial on the part of both the lenders and the real estate professionals — the developers, the managers, the leasing people, the marketing people – we sort of thought that "Yes, we have a problem, but it's a short-term problem, we'll be back after a couple of years." We were wrong. We were in a state of denial. The situation was far more grave than anyone initially thought. It was grave enough that it decimated the world of commercial real estate. It did away with the savings and loan business. It was a huge event that happened. In fact, I think it was even the seed for the overleveraged home finance market today, but that's another story.

Be that as it may, there is a monumental amount of denial right now, and I hear it every single day. People don't understand — and I grant you, it's very hard to get your head around all this because the problems are of a scope that we've never seen before. There's no precedent for what's going on — and even some of the most sophisticated people in the country are living in a state of denial. They fool themselves into thinking that somehow, someway, this is all going to sort itself out. Well, this is not going to sort itself out.

**TCR:** Is it safe to say you're more pessimistic than the last time we talked?

**Miller:** Yes, I am more pessimistic, and I'm more pessimistic because while I am on record as having anticipated all of the problems we are seeing today, I didn't anticipate the rapidity and the intensity of these problems. And that's bad because I don't think we're really even into the meat of the problems yet.

**TCR:** Using the time-honored baseball metaphor, what inning do you think we are in at this point of the crisis?

**Miller:** I continue to think we're somewhere between the 4th and 5th inning. It's hard to say with any precision because there are so many problems that remain to unfold. But I can give you an idea of some of the challenges I think we'll see in 2009. One is that we have a pension crisis in America. That's important not only from a savings perspective but from the perspective of baby boomers who are going to start retiring very soon, but who now find that their pensions have been impacted. The Pension Benefit Guarantee Corporation, the U.S. government equivalent of the FDIC for pensions, is way underwater.

Then we've got the problem with the car

companies. The last time we looked, the combined market cap of Ford and GM was $2.7 billion dollars, about the same as Bed, Bath & Beyond. And, as we're doing this interview, Congress is contemplating a $25 billion dollar bailout. Throwing $25 billion at companies with a $2.7 billion market cap? It's insane and they won't stop at $25 billion. Why? Because it's not about saving the car companies, but rather the labor unions and their pensions. Well, that's a recipe for disaster, because you've got car companies that still won't make money. They can't be competitive and they can't make money saddled with what they call their legacy costs. With the health insurance and the pension costs for the retirees, it's just not going to work. At some point in time, that's all going to go away, whether it's voluntary or involuntary.

There are other problems as well. For instance, you've got real problems with the states right now. California has a $14 billion budget deficit. They have come to the federal government and told them they can't make it unless the government gives them some sort of help. Likewise, you have the State of Michigan, which I think is just going to implode. Ohio, which is not far behind; New York State, which could see its deficit go up into double-digit billions of dollars. Massachusetts. Florida, etc. The list goes on. How are we going to resolve these problems? I have no idea, but you can expect the federal government to try by throwing a lot of money around.

Then there's the municipal bond market, which has been disrupted. Prices on investment-grade municipal bonds are near historical lows, at least at the lowest levels they've been in my lifetime. That means that states and municipalities can't do any work on their crumbling infrastructure.

**TCR:** Obama supporters I have discussed this with now see the entire answer to the country's economic problems as having the government launch the equivalent of a Civilian Conservation Corps. You know, real FDR stuff, with the federal government putting a million people to work rebuilding bridges and highways.

**Miller:** I think that's exactly what they are going to do, and that's exactly what Japan did. Speaking of Japan, you look at what they did in 1989. They lowered rates to 0, and as I'm looking at my screen this morning, the 30-day U.S. Treasury rate is pretty close to 0. And what else did Japan do? They took a bunch of money and made sure that the banks did not have to realize losses. They took all kinds of money and introduced make-work projects, New Deal-type projects, and I believe that's exactly the course we are headed for.

> **"If you just rinse your losses through the system, there's pain, it hurts a lot and a lot of innocent people get hurt, but they are going to get hurt anyway."**

And what that really means is this is going to go on for a long time. That's the problem. If you just rinse your losses through the system, there's pain, it hurts a lot and a lot of innocent people get hurt, but they are going to get hurt anyway. So if you just let the market experience its losses, you're in a much better place, I think, ultimately, than if this thing becomes protracted for a decade. In Japan, they called the years between 1989 and 1999 the lost decade. And I think that's exactly where we're headed as well.

The U.S. is headed for a brand of socialism that we have always rejected at our core.

**TCR:** Of course, there is a big difference between the U.S. today and Japan then. Namely that, unlike the U.S., the Japanese didn't have so many dollars in the hands of foreigners.

**Miller:** That's true and that's why ultimately no matter how much it costs, no matter what they have to do to shore up the system, the government is going to do it. I believe that the government sees that they have only one hope and that's to try to inflate their way out of this mess. I think that they're miscalculating. That has to be part of their thinking, that they can throw money at this thing and inflate our way out of this mess and we'll be good, and I don't think that's right.

**TCR:** In Obama's recent *60 Minutes* interview, he commented to the effect that nobody should pay attention to the deficits next year or the year after.

**Miller:** I think what that means is that there'll ultimately be a currency crisis. Because, really, when you start thinking about what it is that you're buying when you're investing in U.S. Treasuries… it's the taxing authority of the U.S. government – the currency isn't backed by anything real. That's the only thing you can believe in, that the U.S. government has the ability to tax enough to repay you, and the sort of deficits we are looking at means that there is no way the government will be able to cover their bills with taxes. Once the Chinese and other buyers of our Treasuries realize this, we are going to see a currency crisis, there's no question about it, but I don't know when that comes, or what it will look like.

**TCR:** I have to check on the latest data, but there's no question foreigners are no longer buying U.S. Treasuries at anywhere near the same level as previously.

**Miller:** Any kindergartener can tell you that if you keep just printing money, at some point in time, that's going to have a bad result. Unfortunately, that's not where the country is right now, and people really feel that the government is the answer and not private enterprise.

There is a sentiment that's pervasive right now, that people believe that the free market has failed us. People believe that this crisis has arisen due to the free market, because of unchecked greed and capitalism, and that the markets really aren't capable of running themselves. People believe that capitalism has failed us and the only thing left to do is create more and bigger government in order to check us against this threat in the future.

But it was the government that got us into this mess. I mean, after all, I don't think anybody would argue that Fannie and Freddie are largely responsible for some of the biggest problems we've seen in the housing market. Well, Fannie and Freddie weren't free-market companies. And just because the government doesn't have oversight, it doesn't mean that it isn't interfering in the markets in other ways.

It can interfere in a market, it can interfere with licenses, it can interfere with subsidies, and it can even interfere by saying to quasi-governmental companies like Fannie Mae and Freddie Mac, "Hey, we are going to guarantee your bonds." As long as the general consensus from our lawmakers and from the population at large is that the market has failed us and we need more government, then we are headed for some major changes.

**TCR:** You're preaching to the choir. Our readers are very tuned in to the problems caused by bigger government, no matter what label it wears.

**Miller:** There's going to be some things that evolve out of all this that are really important to understand. First of all, all the rules of the game that we've all grown accustomed to are going to change. Probably, third quarter/fourth quarter next year, certainly in 2010, 11, and 12, there's going to be a completely new set of rules that govern life and investing.

For example, the concept of value. We've grown accustomed to what value is, especially in my world, the world of real estate. What do you do to substantiate value? Easy, get an appraisal. I still hear this to this day, and I'm meeting with some of the biggest lenders in America right now, and they're telling me, "Well, look, I'm not too worried about it because I have an appraisal that says $X."

> **"The only bonafide measure of valuation today is what you are actually able to sell a property for. And because there's no liquidity, that is a completely different number than anything you could ever appraise."**

Sorry, but value is no longer going to be what we all thought it was. There's no liquidity out there right now. It used to be value was what some guy said it was or maybe what you could take and do with the property. Value doesn't have anything to do with that today. The only bonafide measure of valuation today is what you are actually able to sell a property for. And because there's no liquidity, that is a completely different number than anything you could ever appraise.

What's really fascinating is that the participants in this market right now, particularly on the distressed side, are looking at rates of return north of 30% if you can believe that. In this low-interest rate environment, in this environment of government involvement, the distressed participants in the real estate market are looking at threshold return rates, somewhere north of 30%. This is a disturbing paradox. That tells you everything you need to know. It tells you that long-term rates are going to go way, way up, and it really has major implications for value. That's why if your readers are out there intending to do anything with real estate, or pretty much anything else, as far as I'm concerned, you have to totally change your expectations of value.

It's very important for you to understand what value is and what it is not. Value is not what somebody says it is. Value is not what you see quoted on CNBC. Value is what some third-party human being with capital, and there are very few of them left, would pay you for that asset. And if they won't pay you anything, I would argue that the value is zero. That is a concept that most people are just unable to come to grips with.

**TCR:** On more of a micro level, I spoke with someone the other day who told me he's sitting on a empty waterfront lot on Long Island that he paid a million dollars for. He was fishing for ideas on what to do with it, because he could use the cash. It's obviously a case-by-case basis, but given your view that real estate is nowhere near the bottom, what would you advise someone in his position do?

**Miller:** He only has two choices. He can either pay the costs involved with holding it for some indefinite period of time until the market has recovered to the point where people can see their way clear to buying expensive home sites, or he can mark it down and hit a bid. And I'm afraid to tell you that that bid is going to be obnoxiously low right now. And it's not about the greed of humanity, but because there is no liquidity.

Anywhere you go, it's the same story. The banks have shut down liquidity, insurance companies have shut down liquidity. Whenever you see this, there's just no liquidity. Centro, which is one of the biggest mall owners in the world, can't get its debt refinanced. General Growth has seen its stock fall to the point where it's almost worthless, and these people were billionaires. You see Donald Trump having to deal with the problems associated with his new tower in Chicago. I mean, some of the richest people in the world cannot find financing. So, it just

isn't out there, and you have to get acclimated to a world where there's no liquidity. That's a 180-degree different world from what we just experienced.

When you start thinking in those kind of terms, it can help you a lot with your decision making. Because if what you're relying upon is some exit somewhere, and everybody out there is still relying upon an exit – well, that's not coming for a long period of time. So the models that are out there for U.S. business, for real estate, for consumer goods, are flawed now. There's just no liquidity and probably won't be until 2011 or even 2012. It changes all the rules of the game.

**TCR:** Are there any bright spots at all in the real estate front at this point?

**Miller:** No, none. I mean, there are areas of the country that are better off than others. Denver, for example, is better than a lot of other markets in the country. I think Austin, Texas is better than a lot of markets across the country, but even so, there are real problems. Charlotte is okay now, although who knows what Charlotte is going to look like after some of the major lenders that are housed in Charlotte start laying people off in serious numbers. So, there are cities that aren't as dire as some other cities in the country, but I don't see any bright spots for real estate right now. I think value is going to depreciate in a major way, and I just don't see anything that is going to help.

**TCR:** How far out do you think the bottom is? I know it's a hard call, but…

**Miller:** On residential or commercial?

**TCR:** Both.

**Miller:** It's really a hard question. On the commercial side, I think there's so much product out there, coupled with no liquidity, that I wouldn't call a bottom until sometime after 2011 and maybe even beyond that. On the residential side, it's unknown because there can be all kinds of false stimuli that will skew the numbers, but I'm going to say in terms of real supply and real demand, probably not before 2011, maybe 2012. That's strictly a guess; I have no idea.

> **"You have to assume one thing going forward, and that is that if you have any need for liquidity right now, you can pretty much pack it in because you're not going to get it."**

**TCR:** Okay. The last time we spoke, you mentioned two shorting targets, Emcor and Corus Bankshares. Thank you very much, because we brought those on board. We got out of Corus Bankshares last month with an 84% return in a couple of months, and our Emcor short is up 124% over the same period.

Any more thoughts on buys or sells at this point?

**Miller:** Well, in terms of specific names, no, but I will tell you this: the number one short in my book is any heavy equipment/construction, many infrastructure provider sorts of companies right now.

**TCR:** What if the government implements a Civilian Conservation Corp-type operation dedicated to rebuilding infrastructure? Won't those companies do well in that scenario?

**Miller:** In that scenario, some of those outfits will prosper, to be sure. But there are far too many firms in that business, and so many of them are not going to survive.

In terms of other opportunities, it is worth looking into the REITs because, no question about it, many REITs will have major problems with debt. And there is no question about it, some of these REITS have debt. You have to assume one thing going forward, and that is that if you have any need for liquidity right now, you can pretty much pack it in because you're not going to get it. I love it when people say, "We'll just go out and raise more money." Well, I've now had conversations with probably 20 or 30 different people that are trying to start equity funds or distress funds, and they can't do it.

There's no money to be raised. I think going to the public markets right now to raise money is dicey, and I think any company with debt that's going to need to be dealt with in the next three to five years is a great place to begin examining for a short or, at least, for a sell if you own it.

In the commercial world, most of the financing that happened outside of the apartment business was done by conduits, and there are no more conduits left, and conduits were doing the stupidest loans you could find. They were doing an advertised 80% loan-to-value, which was usually more closely aligned to a 100% loan-to-value. They were dealing with no coverage. They were all non-recourse loans. Many of them were interest-only loans. Those loans are now gone. You can't refinance them, and if you could, the terms would be onerous.

I'll give you an anecdote on that point. Two and a half years ago, I sold a property here in Denver that I bought for $10.5 million in 1992. I sold it for $24.5 million, which the purchaser financed with a conduit loan for $20 million. Today, because cap rates have eroded, that property is probably worth about $17 million. But the important thing to know is that the best loan you could find for that property today, if you could even find one — and I don't think you can — but if you could find a loan, the best loan

would probably be for $11.5 million, which would come due in 2010, so you'd have to go into your pocket for the difference. Who's going to want to do that? That is the situation for the entire commercial real estate business right now. If you have any debt on your properties, and we all do, and it exceeds a real and honest-to-gosh 70% loan-to-value, you've got a major problem because you are not going to refinance it without reaching into your pocket to balance the loan. I think this scenario is going to play out across the country and continue to spiral out of control.

**TCR:** In recent months, the government has proposed one solution after another, but nothing seems to stick. Even so, we have the Obama administration coming in and a lot of people are pinning a lot of hope on that, you know, that Obama is going to magically come up with some sort of solution to all that ails us. Have you heard anything out of the government that you would rank as a positive? Or, conversely, ideas that would be devastating to the real estate market?

**Miller:** Until everybody gets realistic about letting the market find its own level, there can be no positives. And I've heard a lot of devastating ideas. I think pretty much everything Congress is contemplating right now is going to bear very bitter fruit. We've talked about how that is going to manifest in the home market, and I think the more government involvement in the home market, the more difficult it is to liquify the home market. Same thing in commercial. One thing to think about is the fact that there are no investment banks left. Well, as much as people like to throw rocks at them, we need investment banks. If you are talking about righting the system and having the system we used to have, you can't do that without some investment banking. It can't be done. Well, there's no investment banks right now, so what kind of world are we moving into?

**TCR:** What kind of world do you think we're moving into?

**Miller:** I think we're moving into a government-dominated world with a persistent dearth of liquidity. Yet, ultimately, the only financing that's going to be viable will be private financing or what I call alternative financing. What I've done over many years in the alternative space is going to be, I think, much more of the mainstream. But it won't happen on the housing side because there are too many regulations on the housing side that cap your behavior and cap what you can make.

> **"…the end of every era is the beginning of a new era. And yes, this is the end of a very big and very long era, and we are going out with a bang."**

On the commercial side, I believe we'll see enormous losses after which the void will be filled by private lenders. So, there is some longer-term help there.

But on the retail housing side, because of government involvement, it will be much harder for families to be able to recover from this. It is just the opposite of what most people think. People are screaming for more government. They're screaming for more regulations. They're screaming for more control, and that very regulation or that very control is going to be the thing that debilitates them further. So I see that as a nation, we are headed for bad times.

**TCR:** Where are you personally putting your money?

**Miller:** Right now, the majority of my money is in U.S. Treasuries and I'm going to leave it there until I see something a little more clear cut. Ultimately I'll be investing in distress, but that is probably three to five years away.

**TCR:** So right now, cash is still king.

**Miller:** Cash is king. If you have liquidity today, keep it, do not invest it — this is my recommendation. Whatever you invest in today may be worse tomorrow, and what I'm seeing now is a big premium on liquidity. I think the more liquidity you have in the years to come, the more opportunities you are going to have to create wealth.

**TCR:** Any final thoughts?

**Miller:** Yes, one. It is really important now for people to keep their head on straight. This is exactly the kind of world where you can panic, where you can become depressed, where you can make bad decisions that are skewed because you're fearful, perhaps because you're not secure with your job or whatever. But this is exactly the kind of world where you have to keep a level head. Smart people will always remember: the end of every era is the beginning of a new era. And yes, this is the end of a very big and very long era, and we are going out with a bang.

It's the end of a very long expansion, but it's also the beginning of something new, and that's how you have to look at this because our job is to create opportunity out of what's new and not just surrender and throw up our hands and go kill ourselves. Instead, we have to keep our head on straight, remain objective, remain resourceful, and above all realize that this is not the end of the world, but it is the end of the world we have all grown accustomed to.

And so, like every end of an era, we now have to adapt and that's going to be the key. Are you adaptable? Are you capable of functioning with a new playbook, with a new set of rules, or do you resist change? Do you get depressed by change? While it may seem simplistic, I think a key thing right now is to remain

optimistic, cheery even, despite seeing everything crumbling around you. Just realize that all catastrophe eventually results in an opportunity, and this will too.

**TCR:** A view we very much share. Get as liquid as you can right now, in cash and other assets such as gold that have a ready market, and that are not someone else's liability, and you'll come out just fine. But whatever you do, keep it all in perspective because there's more to life than money.

**Miller:** I see it that way as well.

*[Ed. Note: As previously, we asked Andy if investors could contact him about participating in his various real estate related ventures, and he said he'd be happy to receive emails from Casey subscribers. His email is: amiller@millerfrishman.com.]*

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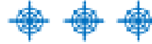

# Casey's Chronicles

**A collection of comments and observations on the passing parade.**

## Big Brother's Big Bailout

**By Bud Conrad**

*(Data current as of November 24, 2008)*

When reporters from Bloomberg recently tallied up the various and sundry guarantees and bailouts proffered by the U.S. government so far, they came up with a jaw-dropping number in excess of $7 trillion. Some of these obligations are guarantees and some involve purchasing assets that will ultimately prove to have some tangible value, so the fiscal impact is less than the headline.

Regardless, the scope of this action is too big to be written off as a "business-as-usual" government program with no real effect on everyday life. To the contrary, the reverberations of this restructuring of the U.S. financial system will affect all of us for decades. To reinforce the importance of these actions, let's start by quickly looking at some of the detail behind Bloomberg's amazing number.

This set of programs is truly way beyond what anybody imagined.

### Government Actions… to Date ($Billions)

| | Maximum | Committed |
|---|---|---|
| **Actions of the Federal Reserve** | | |
| *(59% of Bloomberg Estimate)* | | |
| Commercial Paper Funding Facility LLC (CPFF) | 1,800 | 271 |
| Term Auction Facility (TAF) | 900 | 415 |
| Other Assets | 602 | 602 |
| Money Market Investor Funding Facility (MMIFF) | 540 | 0 |
| Term Securities Lending Facility (TSLF) | 250 | 190 |
| Term Asset-Backed Securities Loan Facility (TALF) | 200 | 0 |
| Other Credit Extensions (AIG) | 123 | 123 |
| Primary Credit Discount | 93 | 93 |
| ABCP Money Market Fund Liquidity Facility (AMLF) | 62 | 62 |
| Primary Dealer and Others (PDCF) | 47 | 47 |
| Net Portfolio Maiden Lane LLC (Bear Stearns) | 29 | 27 |
| Securities Lending Overnight | 10 | 10 |
| Secondary Credit | 0 | 0 |
| *Total Federal Reserve Actions* | *$4.656 trillion* | |
| **Actions of the FDIC** | | |
| *(23% of total Bloomberg estimate)* | | |
| FDIC Liquidity Guarantees | 1,400 | 0 |
| Loan Guarantee to Citigroup* | 249 | 249 |
| Loan Guarantee to Lending Arm of General Electric | 139 | 139 |
| *Total FDIC Actions* | *$1.766 trillion* | |
| **Actions of the Treasury Department** | | |
| *(14% of total Bloomberg estimate)* | | |
| Troubled Asset Relief Program (TARP) | 700 | 350 |
| Fannie Mae/Freddie Mac Bailout | 200 | 0 |
| Stimulus Package | 168 | 168 |
| Treasury Exchange Stabilization Fund (ESF) | 50 | 50 |
| Tax Breaks for Banks | 29 | 29 |
| *Total Treasury Actions* | *$1.15 trillion* | |
| **Actions of the Federal Housing Administration** | | |
| *(4% of total Bloomberg estimate)* | | |
| Hope for Homeowners | 300 | 300 |
| *Total FHA Actions* | *$300 billion* | |
| ***Total Government Actions*** | ***$7,890*** | ***$3,125*** |

Source: Bloomberg http://www.bloomberg.com/apps/data?pid=avimage&iid=i0YrUuvkygWs

### Beyond the Data

I usually focus on the data, preferring to leave opinions to others. But the large numbers above seem to warrant a few added thoughts.

I have often been critical of Alan