

# Lazard Insights Conference Call Series

## The Outlook for Financials

Subprime: Is Commercial Real Estate the Next Shoe to Drop?

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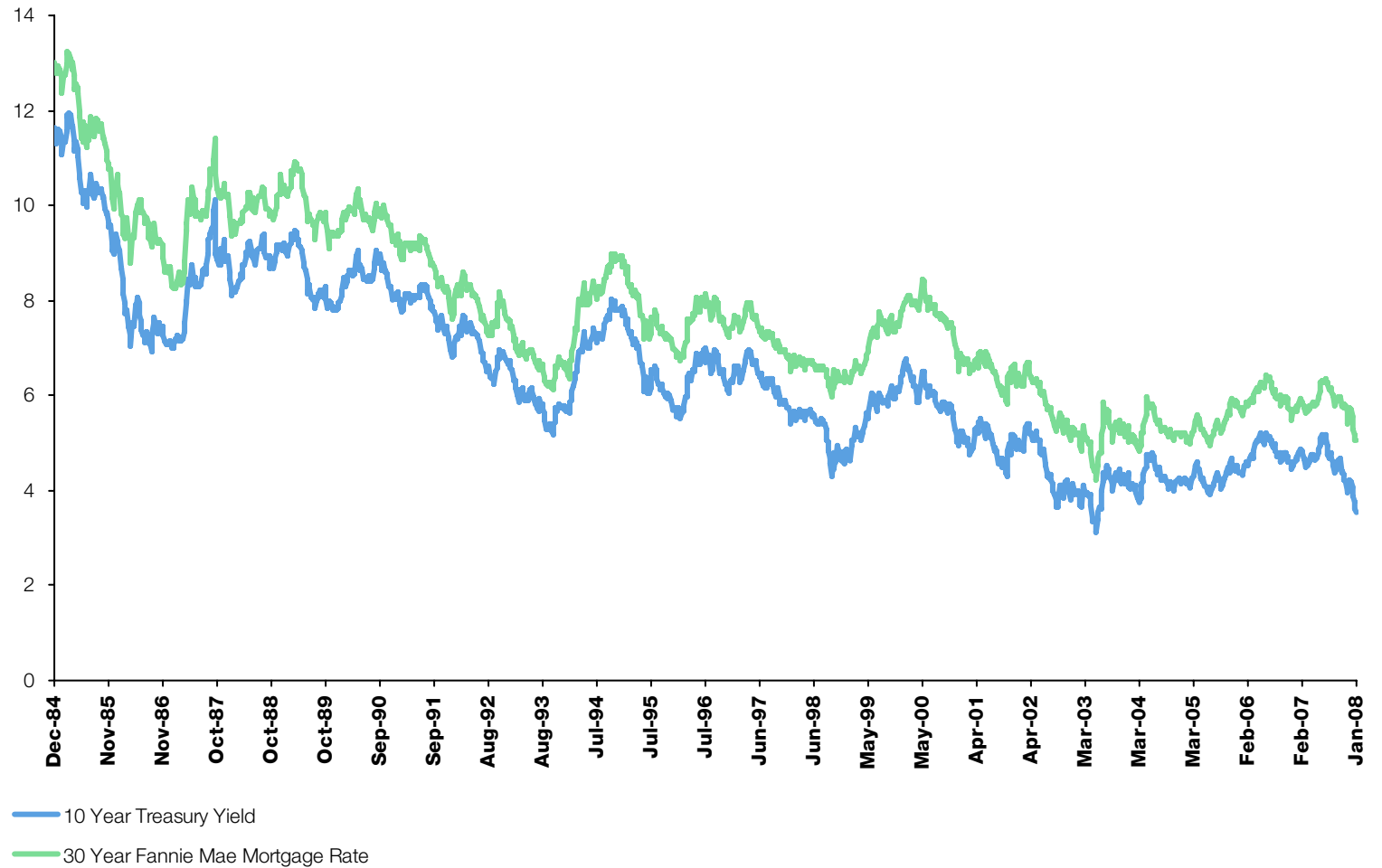


# How Did We Get Here?

- Secular decline in interest rates since early 1980s
- Search for yield and duration drove markets from 2001 to 2006
- Markets enjoyed a virtuous cycle:
  - Lower rates led to
  - Higher prices, which led to
  - Lower credit losses, which led to
  - Lower rates (repeat)
- Compounded by the “benefits” of financial innovation

# Secular Decline in Interest Rates

Interest rates have declined significantly over the last 20+ years

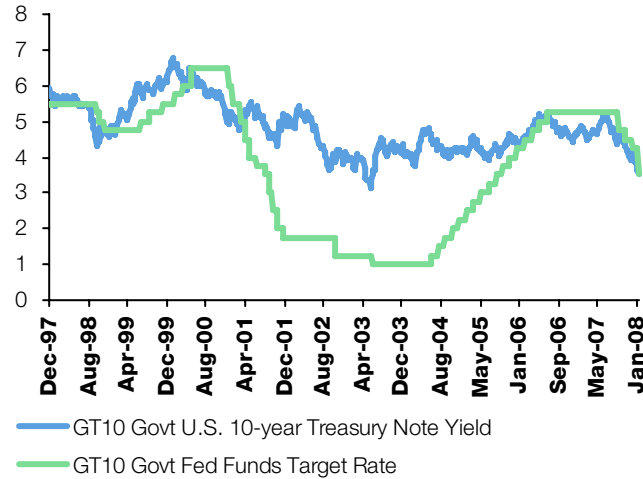


Source: Bloomberg

# Central Banks Cut Aggressively

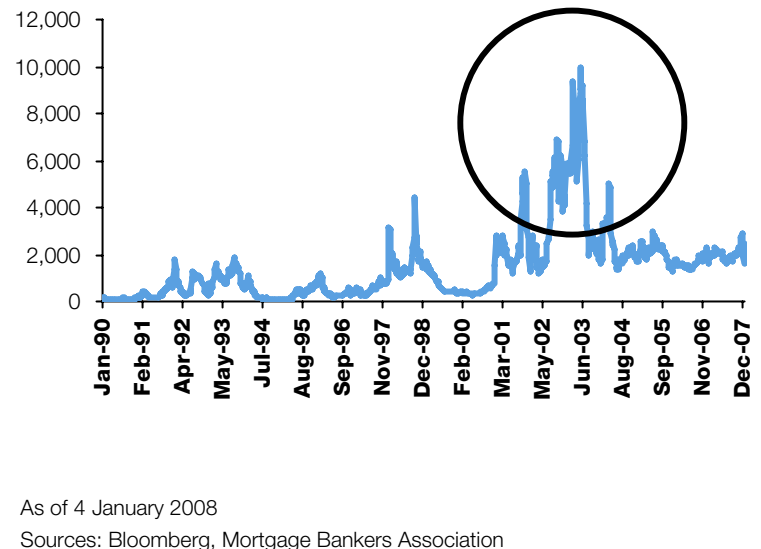
The Fed slashed interest rates, refinancing exploded and prepayment rates reached records

**Fed Funds Target Rate and 10-yr Treasury Yield**

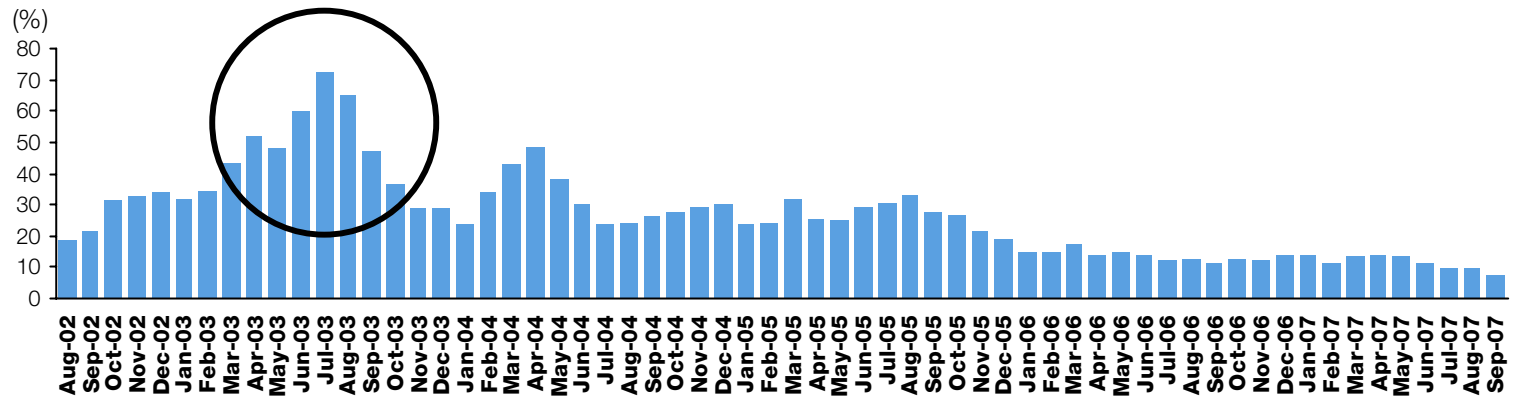


As of 25 January 2008  
 Source: Bloomberg

**Mortgage Bankers Association Refinancing Index**



**Constant prepayment rate for Fannie Mae 6.0% 30 year fixed rate mortgage**

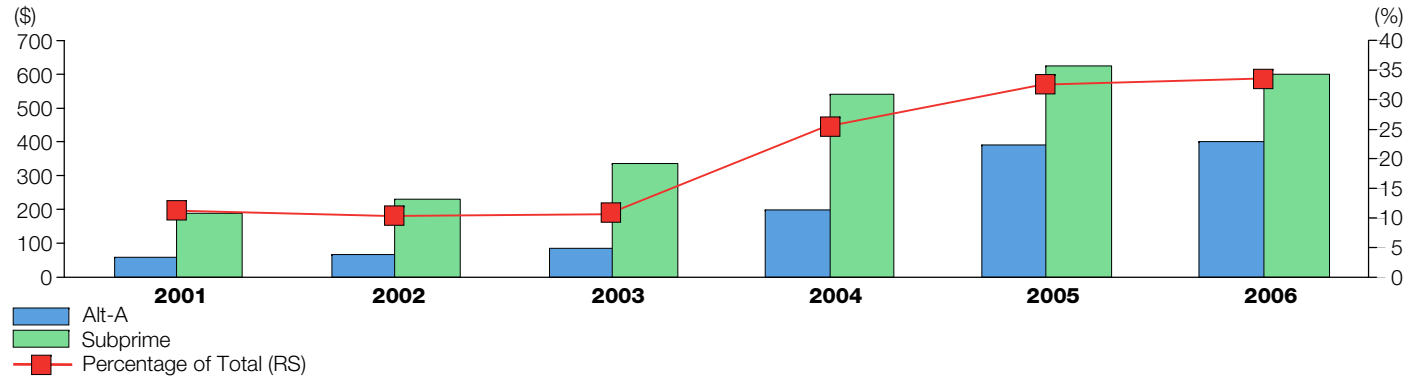


Source: Lehman Brothers

# Financial Innovation Satisfied Investor Needs

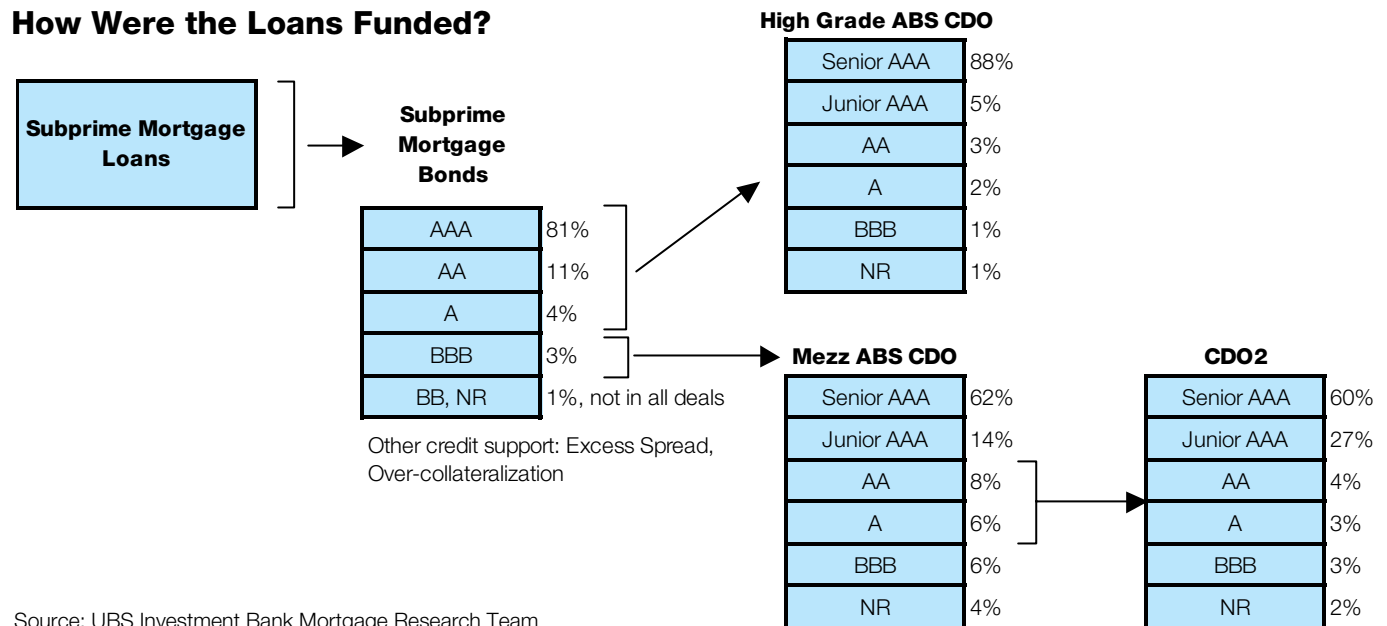
The interests of mortgage originators, Wall Street and investors coalesced

## Subprime and Alt-A Originations Soared



Source: Inside Mortgage Finance (9/8/06)

## How Were the Loans Funded?



Source: UBS Investment Bank Mortgage Research Team

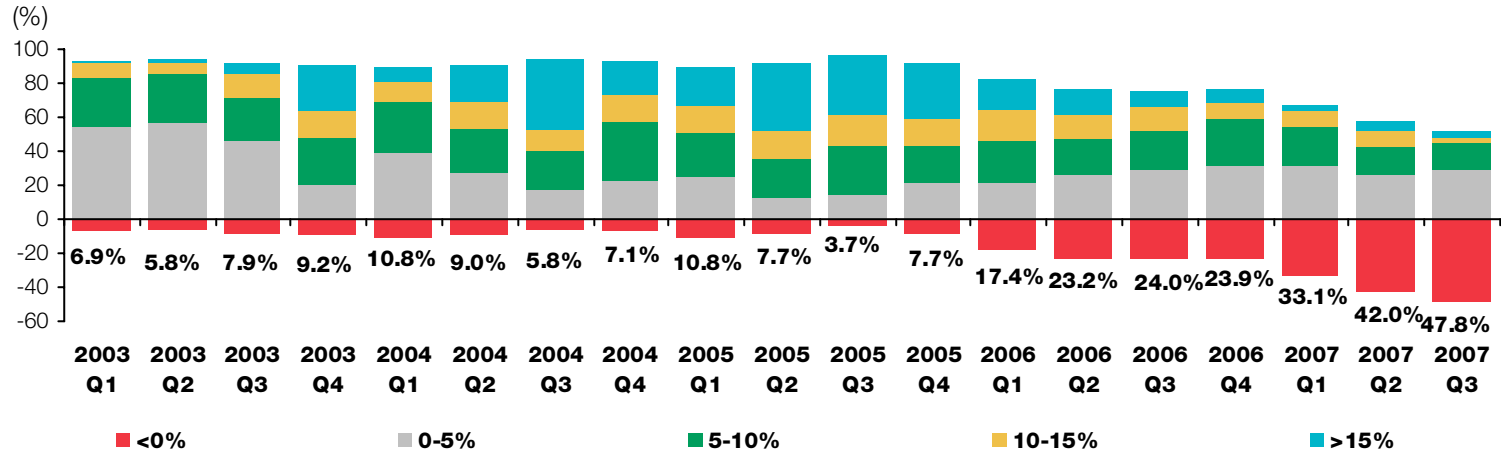
## Not Out of the Woods Yet

- Large number of foreclosures to come
- Home price depreciation accelerating
- Impact on consumer spending and employment still questionable
- Possible contagion to commercial real estate
  - Harry Macklowe default
  - Cosmopolitan Resort Casino
- Changing paradigm - secular interest rate decline has limits

# Risks

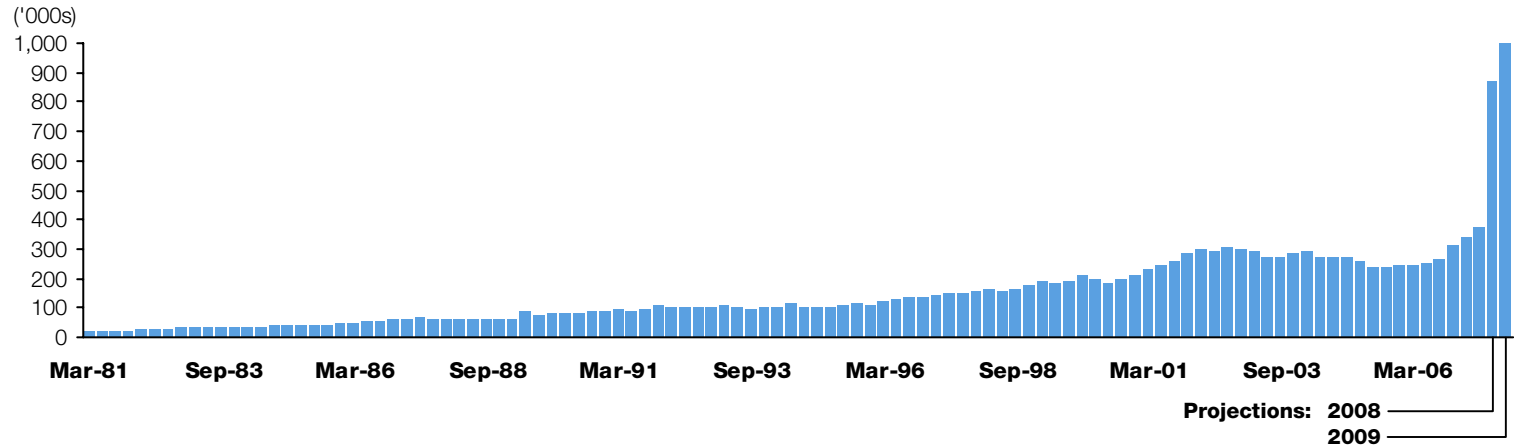
Home price declines are accelerating and foreclosure expectations have jumped

**Quarterly Change in OFHEO Purchase Only Home Price Index (Annualized) by MSA**



Source: Lehman Brothers, Office of Federal Housing Enterprise Oversight (OFHEO)

**Actual Foreclosures Through 2Q 2007; Estimates for 2008/09**



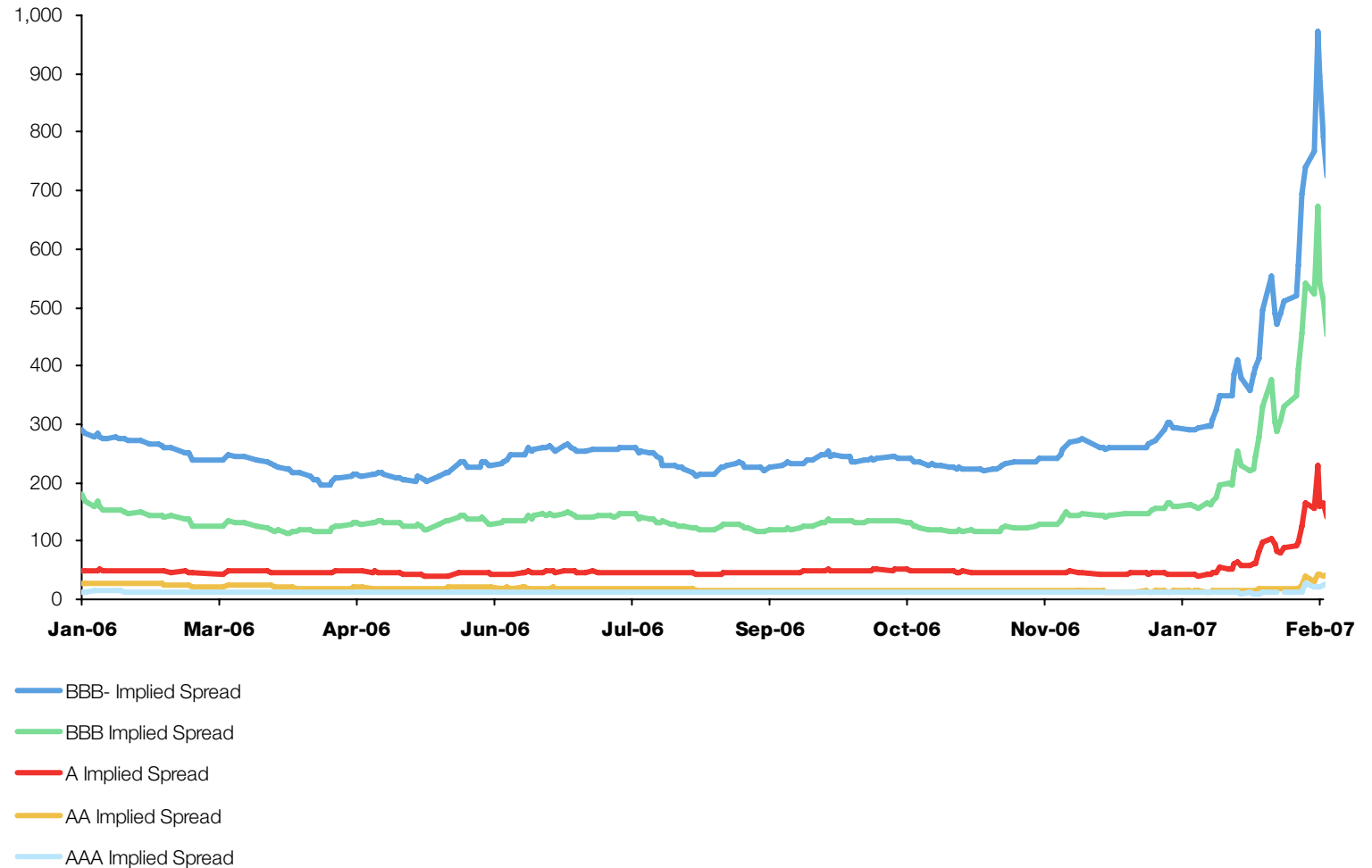
Source: Lehman Brothers

# Cost of Protection on Residential Mortgages

## ABX.HE 06-1

Some investors believe we are in the process of seeing this movie again...

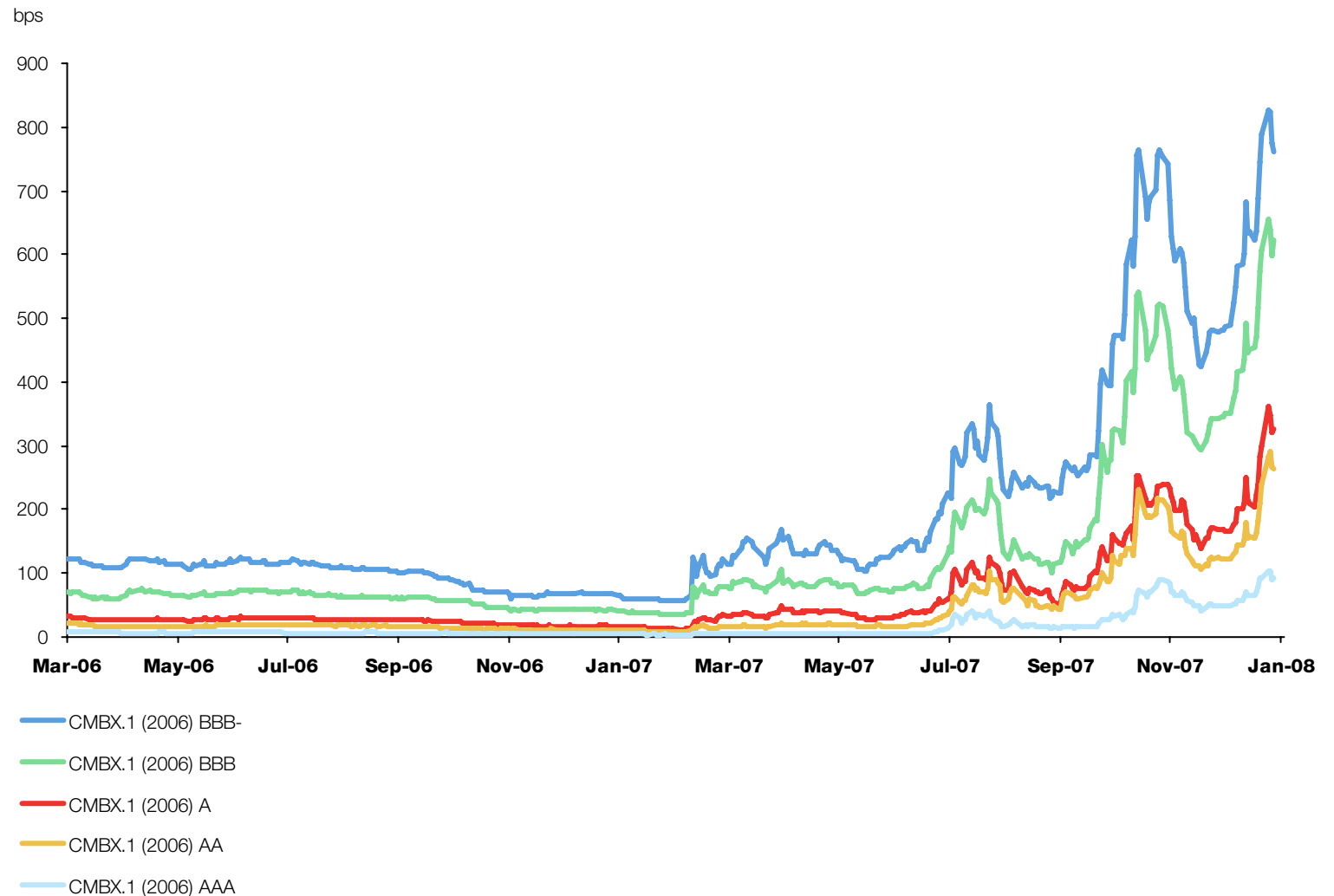
ABX.HE 06-1 Spreads



As of February 2007  
Source: Lehman Brothers

# Cost of Protection on Commercial Mortgages CMBX.1

... in the commercial mortgage industry



As of 25 January 2008  
Source: Lehman Brothers

# Reasons for Optimism

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There are increasing numbers of reasons for optimism

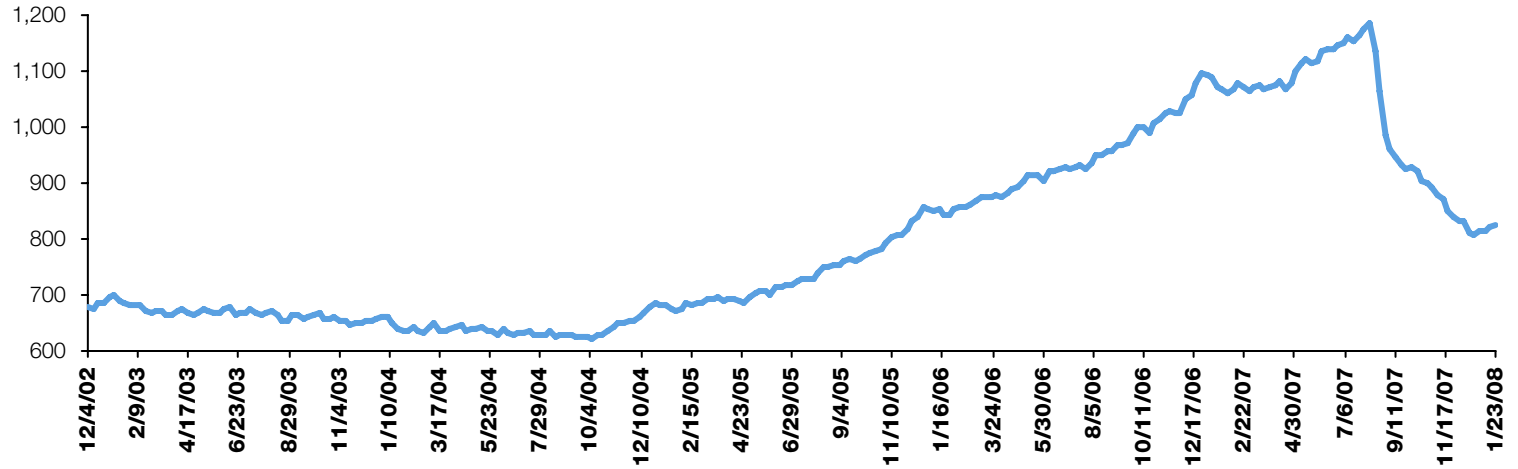
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- Fed injects liquidity through rate cuts and borrowing facilities
- Money markets are functioning again
- Loan modifications are increasingly frequent
- Subprime reset shock has decreased due to lower level of LIBOR
- Prime borrowers seeing decreased debt servicing costs
- Potential fiscal stimulus plan
  - \$150bn of checks to taxpayers
  - Increased conforming loan limit for Fannie Mae and Freddie Mac
- Employment figures remain relatively resilient

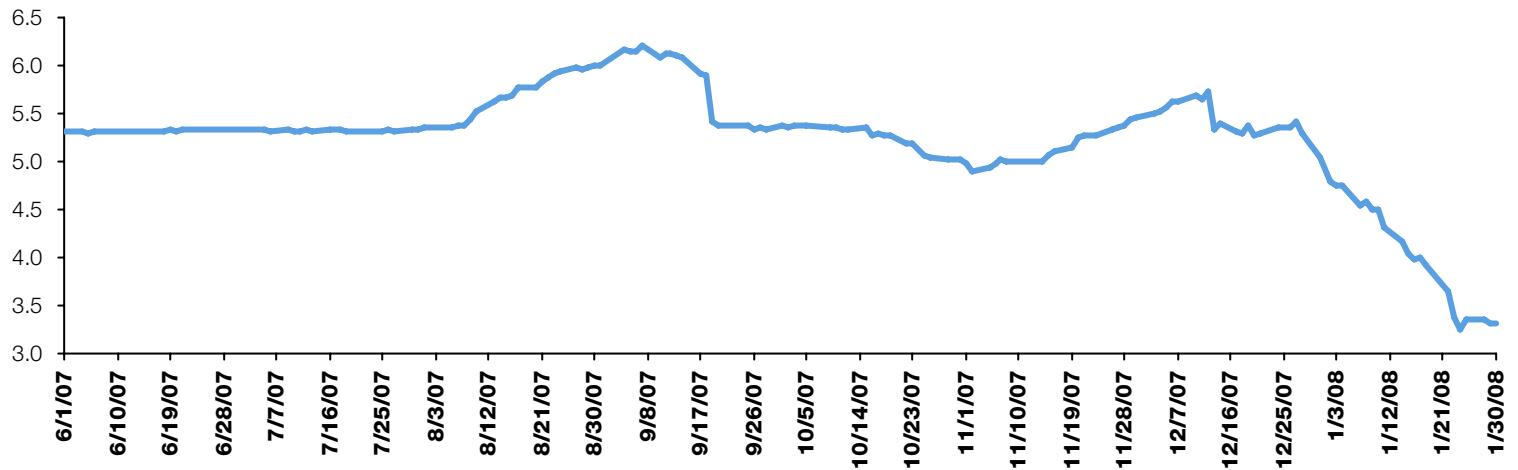
# Money Markets Working Again

After a sharp decline, funding in the ABCP market has stabilized...and the cost of borrowing has collapsed since year-end

**Asset Backed Commercial Paper Outstanding**



**90 Day Asset Backed Commercial Paper Yields**



Sources: Bloomberg

## Where Do We Go from Here?

- Focus on risk of spillover from residential to commercial real estate
- Signs of CRE stress increasing, but from a very good starting point
- Federal Reserve actions make bear scenario less likely
- Same drivers of housing bubble are apparent in the commercial arena
- Key factors to watch:
  - Employment trends
  - Technical factors in the commercial mortgage market
  - Fundamentals of vacancy and rental rates

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