

From: Rossi, Stephen F <stephen.rossi@lehman.com>
Sent: Wednesday, August 1, 2007 2:28 PM (GMT)
To: Yu, Anna <anna.yu@lehman.com>; Traversari, Ryan
<ryan.traversari@lehman.com>
Subject: RE: Archstone article

Not to keep spamming our emails, but for what its worth, I place a big discount on the reputational issue. I believe the market would understand that this is a pure economic decision, and that is why you have cancellation clauses and cancellation penalties. People would just start negotiating bigger cancellation penalties, etc.

From: Yu, Anna
Sent: Wednesday, August 01, 2007 9:47 AM
To: Rossi, Stephen F; Traversari, Ryan
Subject: RE: Archstone article

Steve - You're right about the legal (and reputational) ramifications, but it's still a possibility if the econ losses continue rising. Eric told me yesterday there was a rumour that the TXU deal might be called off (and we might pay the breakup fee). Still just a rumour at this point.

From: Rossi, Stephen F
Sent: Wednesday, August 01, 2007 9:44 AM
To: Traversari, Ryan; Yu, Anna
Subject: RE: Archstone article

Ryan--- there was a pretty big article on this last week in the WSJ when the Citi guy came out with that analysis. I was going to send something to you, Gary, Anna, etc. saying--- maybe I wasn't so crazy after all, but didn't do it. The thing that the analyst ignores is the legal issues. From a pure economic standpoint, probably makes sense to cancel a lot of these deals. But after you factor in suits, etc., probably doesn't.

From: Traversari, Ryan
Sent: Wednesday, August 01, 2007 8:27 AM
To: Rossi, Stephen F; Yu, Anna
Subject: Archstone article

Steve: Not sure if you saw this; but, see the comment from the Citigroup analyst. I think this is the concept that you were inquiring of Gary Fox when we met about these commitments.

Credit Crunch Takes Its Toll
Commercial Real Estate Feels
The Effects of Fewer Buyers
For Pooled Mortgage Securities
By RYAN CHITTUM and KEMBA J. DUNHAM
August 1, 2007; Page B11

The fuel behind the skyrocketing commercial real-estate prices of the past three years -- cheap debt and easy lending terms -- is running low. As a result, high-risk buyers might be left behind and the pace of real-estate companies going private might slow.

Low-cost loans with lenient terms have propelled the commercial-real-estate market to what many feared was an unsustainable level. The boom was propped up by the commercial-mortgage-backed securities markets, which allowed banks to issue mortgages, pool them and sell them as bonds. With less risk on their books, banks were able to lend with cheaper rates and looser terms, making it easier for private-equity firms to buy huge portfolios and real-estate investment trusts. The buying frenzy culminated in Blackstone Group's landmark, \$23 billion acquisition of Equity Office Properties Trust in February. Many of those EOP properties were quickly flipped at even higher prices.

In the past few weeks, though, nervous buyers of these commercial securities have pulled out of the market altogether or demanded sharply higher yields, fearing that many transactions were too risky. That has forced lenders to raise interest rates, increasing the cost of buying real estate.

"I have major REIT clients, and investment banks are changing the deals on them as we speak because their costs of capital have gone up," said Gary Mozer, principal with George Smith Partners, a Los Angeles-based commercial-real-estate finance firm.

Mike Kirby, chairman of Green Street Advisors, a Newport Beach, Calif. real-estate research company, estimates that borrowing costs are about 0.3% higher than they were a couple of weeks ago and as much as 0.9% higher than when Blackstone bought EOP.

The turmoil has led to a shakeout, with highly leveraged buyers stymied and conservative buyers flexing their muscles. Yet, with fewer bidders for buildings and with fewer loans being originated, sale prices could start to fall, experts say.

Investors are fretting over the commercial sector despite strong fundamentals because they see similarities to problems that led to the crash of the subprime residential-mortgage market. This spring, the credit-ratings services issued warnings about lax underwriting standards on commercial loans.

Meanwhile, the market for collateralized debt obligations (which are complex pools of securities backed by commercial mortgages and are big buyers of low-rated commercial-mortgage-backed securities debt) has turned down sharply. "There's an enormous amount of uncertainty and an

enormous amount of anxiety," says Matthew Ostrower, a real estate analyst with Morgan Stanley.

Throughout the boom, many buyers borrowed 85% or more of the total costs of their acquisitions. Many of these loans were underwritten either with the presumption that rising prices would allow buyers to flip the properties for a profit or that future rent increases would offset the high mortgage payments.

In a conference call with investors Monday, Jeffrey Donnelly, senior analyst with Wachovia Capital Markets, predicted that "the high-leveraged investor is probably going to be priced out the market in the near term."

Well-financed investors find themselves at an advantage. For example, Hines Interests, a Houston-based real-estate developer, just closed on its U.S. Office Value Added Fund II, raising \$828 million in equity that will allow for \$2.7 billion of investment. "We are welcoming the change in the debt markets, which will remove some of the potential buying competition," says Dave Congdon, Hines senior vice president.

Another likely outcome is a slowdown in REIT buyouts, which hit a record of \$64.5 billion in 2006, according to SNL Financial.

The biggest pending transaction is Tishman Speyer Properties and Lehman Brothers Holdings, Inc.'s \$15.2 billion buyout of apartment REIT Archstone-Smith Trust. The \$60.75-a-share deal was announced in May, and the REIT's stock dropped below \$59 on fears that Lehman would have trouble offloading the debt.

A report Friday from Citigroup analyst Jonathan Litt speculated that Lehman might find it advantageous to cancel the deal and pay Archstone-Smith a \$1.5 billion breakup fee rather than holding the debt involved in the deal. Archstone-Smith's stock dropped as low as \$56.55 Monday before rebounding yesterday to \$57.41 a share.

While it is still possible for private-equity concerns such as Blackstone to buy REITs, the residual flipping would be more difficult, experts say. "What's happened is the increasingly more aggressive triple flip -- something only Greg Louganis could do -- those types of property trades are not likely to happen again," said Steve Schwartz, co-head of JP Morgan Real Estate.