Understanding Real Estate-Related Debt Investments and Current Market Opportunities in Distressed Debt

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A Picture is Worth a Thousand Slides
AAA Cash Spreads
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Debt Pricing - What Goes Into Yield?

- Inflation
- Real yield
- Maturity
- Structure
- Credit
- Liquidity
### Understanding Real Estate-Related Debt Investments & Current Market Opportunities in Distressed Debt

#### Historic & Current Pricing of Debt & Equity:

<table>
<thead>
<tr>
<th></th>
<th>Long-Term Historic Rate</th>
<th>Standard Deviation</th>
<th>Current Pricing</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inflation</strong></td>
<td>3.0%</td>
<td>3.0%</td>
<td>2.0%</td>
</tr>
<tr>
<td><strong>Treasury Bills</strong></td>
<td>0.7%</td>
<td>3.1%</td>
<td>-1.9%</td>
</tr>
<tr>
<td><strong>5-Yr Treasury</strong></td>
<td>2.3%</td>
<td>5.7%</td>
<td>-1.1%</td>
</tr>
<tr>
<td><strong>Intermediate Corporate Bonds</strong></td>
<td>2.8%</td>
<td>8.6%</td>
<td>0.2%</td>
</tr>
<tr>
<td><strong>Large Cap Stocks</strong></td>
<td>7.0%</td>
<td>20.4%</td>
<td>5.5%</td>
</tr>
<tr>
<td><strong>Small Cap Stocks</strong></td>
<td>9.3%</td>
<td>33.0%</td>
<td>7.0%</td>
</tr>
</tbody>
</table>

#### Other Markets

<table>
<thead>
<tr>
<th>Market</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>FNM Current Coupon</td>
<td>2.84%</td>
</tr>
<tr>
<td>CMBS AAA 5-Yr</td>
<td>2.75%</td>
</tr>
<tr>
<td>Equity Res. BBB+</td>
<td>2.60%</td>
</tr>
</tbody>
</table>

The debt markets are very expensive. Searching for alternative strategies is highly worthwhile.

All numbers except inflation are real returns.
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The Foundation for Debt Pricing is the Federal Funds Overnight Rate: **0.00%**
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- **Innovative Strategies** – Equity like returns with bond volatility

- **Focus on Sectors That Have Been Disrupted, Regulated, and That Are Small**

- **Direct Lending** – Bank oversight and risk taking has moved away from the sector: 12%

- **Mezzanine Finance** – Traditional financing is still challenging: 8-10%

- **Orphan Sectors** – Non-Agency RMBS: 10%

- **Replace Debt with Similar Cash Flow & Volatility** – Single family REO-to-rent
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Sources of Debt

- Traditional sources of CRE debt capital remain under stress and are not functioning at their historical capacity.

- Commercial banks estimated to hold $1.5 trillion or 42% of commercial mortgages and have limited capital to make new loans.

- Life insurance companies are also beginning to come back into the market but only for specific asset types.

- Although 2010 origination volume increased when compared to 2009 (the decade’s trough), 2010 was still 77% lower than 2007 (the decade’s peak).

Source: Federal Reserve Flows of Funds, 3Q11
US Commercial Real Estate Originations peaked in 2007 with low-cost, CMBS lending as a key driver.

2007 to 2009 (peak to trough), total origination volume declined by 84%; CMBS issuance nearly shut-off while decreasing by 99%.

Source: Mortgage Bankers Associations Annual Origination Volume Summation 2010. This information was received from sources believed to be reliable and accurate. However, no representation or warranty is made as to such accuracy. Readers should consult primary sources where appropriate.

* Mortgage Bankers Origination Index estimates quarterly origination volume, which was extrapolated against actual historical originations.
CRE Transaction Volume

- Severe and prolonged decline in CRE transaction volume.
- Valuations are 46% higher than the lows of second quarter of 2009, but are very market/asset specific.

Source: Real Capital Analytics (www.rcanalytics.com). As of November 2011. Based on independent reports of properties and portfolios $5 million and greater. This information was received from sources believed to be reliable and accurate. However, no representation or warranty is made as to such accuracy. Readers should consult primary sources where appropriate.
Large volume of near-term CRE loan maturities with historically limited sources of new capital (unchanged)

Maturity extensions continue to be a common theme for lenders – delaying rather than removing demand from the system

Over the next three years approximately $7 trillion of CRE loans will require resolution providing ample opportunity for NSREIT to selectively offer capital to strong sponsors / high quality properties
CMBS

- CMBS originators manufacture loans specifically to be sold off to investors, and are hedged during this period.

- When markets are volatile hedging strategies can be ineffective.

Commercial Banks

- Primary focus is on cleaning up portfolios of existing loans.

- New origination activity is targeted at low-leverage loans with strict terms (i.e. full recourse).

  - Are only able to address a small sub-set of potential borrowers that require new debt capital.
A significant imbalance between commercial real estate debt capital supply and demand has created a compelling investment environment.

The Sponsor has the specific expertise and track record in making commercial real estate debt investments.

Taken together, we believe a significant opportunity exists to make investments for NorthStar REIT with risk-return characteristics that are potentially favorable to our shareholders.
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Follow-Up & Questions