

Interview

Beware of False Dawns

An Interview with Joseph E. Robert, Jr.,
 Founder and Executive Chairman, J.E. Robert Companies



Joseph E. Robert, Jr.

EDITORS' NOTE In 1990, Joseph Robert founded Fight For Children and continues to serve as its Chairman. In addition, he is Chairman of Business Executives for National Security (BENS), a nonpartisan national organization of senior executives dedicated to enhancing our national security. Robert is Chairman of the U.S.-U.A.E. Business Council, a collaboration of leading companies based in the U.S. and U.A.E, committed to expanding bilateral commercial opportunities between the two countries. In 2008, Robert was honored by the EastWest Institute, together with former Secretaries of State Henry Kissinger and George Schultz, former Secretary of Defense William Perry, former U.S Senator Sam Nunn, and Dr. Mohamed ElBaradei, for his leadership to improve national and international security. Robert was appointed by U.S President George W. Bush to the Board of Trustees of The John F. Kennedy Center for the Performing Arts. He is Chairman of the Washington Scholarship Fund, a nonpartisan nonprofit organization dedicated to increasing educational opportunities for low-income students and families in Washington, D.C. He was Chairman of the successful \$300 million Comprehensive Campaign at Children's National Medical Center in Washington, D.C., including his \$25 million contribution, which resulted in the construction of the state-of-the-art Joseph E. Robert, Jr. Center for Surgical Care. Robert served as Vice Chairman of the Board of the National Realty Committee and is a founding member of the Real Estate Roundtable. He

is also a member of the board and executive committee of the Peter G. Peterson Institute for International Economics and a member of the board of the Horatio Alger Association. Robert is a member of the World Economic Forum, the Trilateral Commission, World President's Organization, Chief Executives Organization, Council on Foreign Relations, Foreign Policy Association, the Urban Land Institute, and The Bretton Woods Committee. Robert was awarded Honorary Doctorates from St. John's College and Mount Saint Mary's University.

COMPANY BRIEF J.E. Robert Companies (www.jer.com) is a real estate investment management company with more than 28 years of experience in sourcing, underwriting, and managing a broad spectrum of real estate equity investments and debt products in the U.S. and Europe. Together with its financial and operating partners, J.E. Robert Companies has purchased and managed approximately 15,000 assets totaling \$28 billion. The firm also invests in CMBS, mezzanine financing, and other structured debt products.

Do you feel that the economy has found its way to the road of recovery yet?

My suggestion is to beware of false dawns. The job market and the way they analyze unemployment can easily lead one to the wrong conclusion. We're in an economy that is 70 percent consumer-driven, which for many years now, has relied upon roughly \$4 of credit expansion for every \$1 of GDP. That being the case, our entire credit system has virtually collapsed. Consumer credit continues to tighten and it is not expanding. That is true with respect to most business credit as well, particularly to medium-sized and smaller businesses. Unemployment continues to rise and we're going through a profound cultural shift away from consumption towards savings. That is not necessarily a bad thing, except it is coming at the wrong time. Those are the things, from an economic standpoint, you hope would happen during economic expansion and job growth, not times like this.

A lot of consumer, business, and real estate credit relied heavily on the securitization market. Today, there is effectively no securitization market. When you look further at consumer spending, you realize there is a high percentage of consumers – particularly in this job market,

which has roughly 15 or 16 percent either unemployed or underemployed – who are not buying, except when they have to. The next 10 percent above that are scared they're going to lose their jobs, so they're not spending much either. So those things do not bode well for the balance of this year.

Stimulus packages work, but the effects tend to be short-lived and they're going to go away. Twenty percent of the stimulus got into the market immediately, and the balance is to be spent over the next five years, which means, in the short term, you're not going to do very well.

If you focus on the real estate side, real estate essentially houses the economy, and at the end of the day, it is about jobs. If you continue to have erosion in the job market, this tends to feed on itself, not only from an economic standpoint but on the real estate side as well.

I read recently that income from office buildings and investment property tends to stabilize where even nonperforming loans, from a value standpoint, continue to perform. That is extremely misleading, because tenants in America are trying to re-price, so these leases roll over, and they're not going to have the operating income that they had in the past. Investors have not lowered their return expectations, and some could argue that they are higher than they used to be, which has a direct impact on values because if credit rates essentially creep up, that will have a reverse effect on valuation.

The credit markets are virtually nonexistent and the system providing credit has been broken. Most of the Wall Street houses that did securitization let those departments go some time ago, because there wasn't any business. The bond markets have been unable to price credit risk and they're unlikely to be able to do so, unless they're convinced that we've essentially reached bottom on values, and in effect, leverage has come back into the market.

So my belief is that the road ahead for commercial real estate, at least for the next year or two, is rocky at best and will worsen almost no matter what we do.

Your forecast for commercial real estate is bumpy. There are those who look more on the risk side of it and talk about that being the next shoe to drop.

This is difficult, particularly for regulators. It's like trying to surf a tsunami from behind the wave. They can't move fast and aggressively enough, nor is the infrastructure there to get ahead of this wave, which means, it is coming and it is going to hit landfall over the course of the next year or two, no matter what we do. There is not enough money out there to handle this coming crisis. You look at the amount of refinancing that has to take place over the course of the next couple of years, and it is staggering. There is no capital available, for the most part, for refinancing. There are \$3.5 trillion in commercial real estate loans outstanding, and \$1 trillion of that is going to come due over the course of the next three years. The average loan-to-value is essentially now 100 percent versus the 65 or 70 percent of origination. The expected losses on the loans are about \$700 billion, which includes construction loans, through the cycle, and three big holders of these loans are banks that have 52 percent, two-thirds of which are held by smaller and regional banks, which have been the biggest credit providers to small- and medium-sized businesses; CMBS and other securities product with 21 percent; and insurance companies with 10 percent. If you just focused on the smaller and regional banks, many of them are going to fail as a result of the problems with non-performing loans on the real estate side.

Securitization is basically gone, and you don't have the staff infrastructure to kick-start it – that is going to take some time to build up. You've got some providers who are out of business, like Lehman Brothers. Other providers are going through the new regulatory process and don't know what it is going to look like, so they're not going to take a risk without understanding, from a regulatory standpoint, the full weight of the burdens that will be imposed on them. So we've just begun experiencing the problems, and the losses are likely to be severe; they are going to put quite a number of lenders under. The economy as a whole, particularly in the investment product side has, in effect, gone through a deflationary de-leveraging process whereby we can't pay the debt down fast enough to bring the leverage down to a manageable level. That's going to create, for many, a cash flow trap, because as values come down, you're forced to pay down leverage with all of the cash flow you have, and as the values come down, the value of that leverage in the credit market is lower. All the while, investors continue to have the same return expectations, which they can't get because of the lack of financing available in the market. You've got an entire industry that, for the most part, relied upon, grew, and was dependent upon leverage.

You have many years experience in leading businesses. Can you apply some of the lessons you've learned today, or are we in a different scenario?

We're in a different situation in a number of ways. Loans are far more complicated to work out today than they were in the past. It used to be that you sat across the desk from a banker who either originated a loan or worked for the institution that holds the loan. There wasn't a

secondary market for non-performers, so they didn't get traded. However, you had a face to deal with and it knew what it could and could not do. A lot depended on whether they were operating under a supervisory board or what their own capital situation was, but you could get a deal done.

In the CMBS market, you're dealing with a sea of unknown bond holders within a structure that makes it very difficult for them to organize. In many cases where you have a master servicer or a special servicer, the master servicer can't negotiate anything, so if the developer or investor has a loan and that loan is not performing or is not likely to, the master servicer can't do anything, so the loan goes into default. The special servicer is not in a position to even talk to the borrower until well down the road. And the communication system between the master servicer and special servicer is frequently inadequate to get ahead of the curve. So it's more complicated than it used to be.

In every previous cycle, there tended to be some credit available somewhere. Even in a downturn like the late '80s and early '90s, with guarantees, you could find credit, particularly in the low end of the market – \$2 or \$3 million. You could put together the equity and go out for loans at a local community bank – you can't do that today. We didn't have a securitization market, so it was less complicated, and nonperforming loans back then couldn't trade. Today, they will trade, but at yields that make banks quite reluctant to sell them.

How has your business evolved during this time, and how have you positioned the business to succeed in this type of market?

We have continued to beef up our special servicing capabilities. Special servicing is a business we essentially created in an industry that didn't exist, and was the foundation of starting the business in 1981. We didn't call it special servicing until a decade later when the first securitizations came out, and we were among the very first securitizations that were ever done. We literally had to teach the ratings agencies, which had no real estate department, the risks to the cash flow, how you exit these loans, and how you identify the risks. We know this business very well, and for 28 years, we believe we've had one of the best loan workout platforms in the nation. Today, we are the special servicer to a CMBS loan pool of approximately \$47 billion and are currently managing more than \$3 billion in non-performing loans." So that area of our business continues to grow, and we expect it to continue to grow.

We are limiting our investing at the moment because we don't think it is the right time in most markets. We are very focused on managing the investments we made, particularly in 2007 and 2008, which have been negatively impacted by the economy. Up until 2008, we projected no capital losses at the fund level, but over the past couple of years we have not been immune to the impact of the economy. So we're very focused on maximizing the recovery on the assets that we already own. We're not focused on the deal side.

We've restructured the company internally to bring on board the kinds of skill sets that are much more experienced on the workout/restructure side, and less on the deal-making side. We've brought in a new CFO on the holding company side who has enormous experience in this area. Because of my health issues, we brought in a new CEO who has a lot of the same kind of experience I've had going way back. He is extraordinarily bright, spent 10 years on the limited partner/investor side, has international experience and has seen it all.

There are many who have had the opportunity to work closely with you and know you very well. If I was talking to some of them without you in the room, and I asked what it was like to work for Joe Robert, what do you think they'd say?

They'd say he's driven, an extremely hard worker, and that he's very focused on the mission, which has never changed, and on overall strategy at the macro level, as well as on accomplishing certain goals and objectives, which have been embedded and are part of the company's culture. He's also someone who has stuck to the operating principles of the company, starting with a value system that is based on integrity. Your reputation for integrity is like very fine Baccarat crystal – if you crack it, then you can glue it, tape it together, or wrap something around it, but it is permanently cracked. So we go to every length to make sure that our reputation for integrity is never jeopardized.

You are a leader around philanthropy and community, particularly regarding issues with children. Was that instilled in you early on?

There is a Catholic Priest who has been enormously influential in my life, starting around the fourth grade, who gave me a sense that the work that I do on the philanthropic side is a moral obligation. I made a lot of money over the years and I've given the majority of it to children's causes.

One of the goals and objectives of the company has always been to be a financial and intellectual asset to the communities in which we live and work, so it's embodied in the culture of the company. I also come from a family who experienced economic difficulties during the early years when I lived at home. I became a mentor to a troubled youth early on, and I now run a gym that I took over from the city 25 years ago. We have 40 or 50 disadvantaged kids in the program, and it's a very important part of my life. We can all give back in so many different ways – not just a check. It's time and thought and should be an integral part of your life.

You touched on the fact that your hours may not be what they were, yet many would still consider them full-time. It seems the notion of Joe Robert really slowing down is hard to imagine. Will that time come?

Yes. When they put me on the other side of the grass, but until that time, with the very last breath I take, I am going to be swinging at something. That's just in my DNA. ●