



Public-Private Investment Program (PPIP)

Overview

The Public-Private Investment Program (PPIP) is a U.S. government sponsored program introduced in March of this year to help address the problem of “toxic” assets within the financial system. These assets are primarily real estate related securities (residential mortgage backed securities – RMBS, and commercial mortgage backed securities - CMBS) issued prior to 2009 (i.e., legacy assets) and currently being carried on the balance sheets of financial institutions (in some cases at values significantly below par). The government’s objective with PPIP is to draw private investment capital (along with government capital) into the mortgage backed securities market to provide liquidity for legacy assets thereby freeing U.S. banking institutions to extend new credit. From an investor’s perspective, PPIP’s objective is to generate attractive investment returns.

PPIP was formed as an expansion of the Term Asset-Backed Securities Loan Facility (TALF, which remains a separate program from PPIP) created in November 2008 and launched earlier this year by the Federal Reserve. TALF primarily serves to increase the availability and extension of consumer credit which had stalled after the global financial crisis began in 2007. When the government first announced the TALF loan program, it was geared towards encouraging the issuance of *new* credit card receivables, auto loans and leases, student loans, and small business loans by providing attractive incentives to investors. Recently, TALF (now known as TALF 1.0) was expanded to include other types of securities such as newly issued and legacy CMBS and non-agency RMBS (TALF 2.0). These are some of the same assets targeted by PPIP.

A Brief Summary of PPIP

Through the PPIP program, the U.S. Treasury will use up to \$100 billion in capital earmarked for the Troubled Asset Relief Program (TARP) to co-invest alongside private investors in eligible legacy securities (CMBS and non-agency RMBS issued prior to 2009 and originally rated AAA). As such, private co-investors will share investment risks with the government and will also play an important role in establishing the prices of legacy securities being purchased. The PPIP program was originally created with two investment components – one for purchasing legacy loans and the other for legacy securities. As of June 3, 2009, the legacy loan program has been postponed, but the legacy securities program presses on.

The U.S. Treasury, through the legacy securities program, will match dollar for dollar the equity capital provided by private investors in one of nine newly created Public-Private Investment Funds (PPIFs). The PPIFs will be managed by fund managers recently approved by the government. The U.S. Treasury will

also provide between 0.5x-1.0x of senior secured, non-recourse debt financing for each equity dollar invested (both private and public), creating up to a 1:1 debt to equity ratio. If the PPIF opts for a half turn of Treasury debt (0.5x total equity) it may also be eligible for TALF financing from the Federal Reserve. Under this scenario, total fund leverage may reach 5:1. Most PPIFs, however, are expected to opt for a full turn (1.0x total equity) of Treasury debt, which carries a financing cost of LIBOR plus 1.0% (plus a warrant for 2.5% deferred distribution). Under this scenario, additional leverage is not permitted. Each PPIF is expected to raise \$1.1 billion in private investor capital or approximately \$10 billion in total (9 x \$1.1 billion), thereby creating \$40 billion in aggregate purchasing power.

Notable Differences between TALF and PPIP

Despite their interrelation, there are many differences between TALF and PPIP. Some of these differences lend support to the notion that TALF, despite higher leverage, is a more conservative investment option than PPIP. The table below identifies key differences and helps distinguish the two programs from each other.

	TALF	PPIP
Securities	Mostly Newly Issued Securities	Legacy Securities
Date of Issue	After 1/1/2009 (New Issues) ¹	Prior to 1/1/2009 (Legacy)
Source of Return	Income	Capital Appreciation and Income
Acquisition Price	At or Near Par	Deep Discount
Ratings / Quality	AAA-rated at Purchase / Higher Quality	AAA-rated at Issuance / Lower Quality
Investment Period	Through 12/31/09 ²	Limited to 3-Years
Program Duration	Up to 5-Years	Up to 10-Years
Financing	At Security Level	At Fund Level
Financing Amount / Source	Up to \$1 Trillion from Federal Reserve Bank of NY	Up to \$100 Billion (Equity and Debt) from Treasury
Eligible Investors	U.S. Investors	U.S. and non-U.S. Investors
Credit Risk	Lower	Higher
Investment Sourcing	New Issue Market / Secondary Trading	Financial Institutions / Secondary Trading
Eligible Assets	ABS, CMBS	CMBS, Non-Agency RMBS

¹ Legacy MBS securities still rated AAA have been added to TALF 2.0 ² Currently being reviewed for extension.

Pros and Cons

PPIP is similar to TALF in that both have been introduced with little time for the potential investor to analyze and understand the programs' respective benefits and risks. This will likely also be the case for future government programs introduced to loosen U.S. credit markets. We think the following table is helpful

in weighing the pros and cons specific to PPIP as investors fight the clock to understand this unique investment opportunity.

	Positives	Negatives
Valuations	Securities with seemingly attractive loss-adjusted yields due to pessimism and technical issues in the market	Valuations may not fully capture weak real estate fundamentals – lower rents and home prices, higher vacancies and delinquencies, supply and demand imbalance, massive refinancings in 2010-2011
Spreads	Spreads are high, success of the program may lead to more spread tightening and higher prices	Spreads have tightened considerably as a result of the announcement of PPIP and could contract even further – reducing long term return potential
Protection	Senior securities (although some PPIFs are targeting higher yielding eligible assets), securities originally rated AAA	Leverage may amplify losses, maximum downside is 100%
Motivations	The government is committed to reducing the level of distressed assets of banks, banks may sell to free up capital, may be forced to sell by regulators in certain circumstances	Banks are not as motivated to sell assets as they were earlier in the year (more confidence in the market, easing of mark-to-market accounting rules, possible capital ratio implications)
Liquidity	Managers have more discretion to provide interest distributions over 8% in first 3 years	No voluntary withdrawals throughout program, limited distributions through first 3-years or until government debit is retired
Opportunity Set	Broader opportunity set than TALF, an estimated \$3 trillion in eligible assets, diversified across sectors, vintage years, geography, etc.	Securities may extend beyond the end of the program, securities with unique and complex structures make them difficult to analyze, eligible assets may be expanded

Conclusion

We recently identified TALF as an attractive and unique investment opportunity for certain clients, but recognize that timing has been of the essence. Investors have had some difficulty putting money to work as demand for TALF investments has outstripped supply and investment spreads have already contracted a substantial amount. After reviewing available PPIP information and materials, we believe the program has merit and certain PPIF offerings are more appealing than others. At the same time, if an investor has a strong desire to participate as an investor in the CMBS and RMBS markets, we believe PPIP provides competitive advantages for the PPIF investment manager.

A summary of our review of the PPIP program with a focus on risks follows:

- PPIP provides access to non-recourse leverage on favorable terms (1% over LIBOR). Of course, as with all investments, leverage increases returns *and* risks;

- Credit risk appears much higher under PPIP than TALF given the reported toxicity of underlying legacy securities to be purchased and continued weakness in the underlying fundamentals of the real estate marketplace. Proper valuations of securities will be essential;
- It is unclear what will motivate banks to sell legacy assets as they now have options to retain them at cost under certain circumstances. However, banking regulators may pressure some banks to remove toxic assets from their balance sheets. In addition, the PPIF managers are not limited to purchasing assets from banks. Hedge funds, insurance companies, and liquidating CDOs are also possible sources. Furthermore, if bank closures accelerate, as many expect, the FDIC may be a major force behind the sale of assets;
- Cash flows in the form of interest payments to investors are expected to be limited during the first three years and disproportionately in favor of the U.S. Treasury until debt is eliminated. Consequently the return of investor capital may take several years;
- This recession may be far deeper than anticipated and the appreciation portion of the program's potential return may not materialize for quite some time, if at all. Many of the PPIF managers acknowledge this possibility, but still believe the program represents a good opportunity even with very conservative estimates and bearish outlooks;
- As PPIP is a government program there is always the possibility that rules will change (i.e. new legislation, eligible asset changes, constraints added, taxes on profits, eliminate the program, etc.), potentially disadvantaging investors. Given the longer investment horizon and limited liquidity of PPIP (i.e., three year investment period, seven year distribution period, no withdrawal rights) relative to TALF, investors are exposed to an increased risk of government redirection;
- For investors who have liquidity and want to invest in real estate debt, a conservative PPIF manager could provide a reasonable PPIF vehicle. However, investors should be careful to choose a fund with terms that align the manager's interest closely with those of the investors.

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