REAL ESTATE PRIVATE EQUITY FUND INVESTING
Profound Changes for the Road Ahead

Winter 2010
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Introduction

Little research and commentary are available for institutional investors focused on opportunistic real estate fund investing. Notwithstanding the recent meteoric growth in the opportunistic real estate fund asset class, most data and commentary continue to be focused on property and capital markets issues. This white paper continues Probitas Partners’ tradition of offering research, insights and recommendations to help investors and fund sponsors understand and react to what is happening in the real estate funds market and to best position their portfolios to take advantage of the resulting opportunity.

Last year, as the markets began their free fall, we released our brief for investors that included anticipated impacts, recommendations on current portfolio management, and ideas on how to position themselves to invest in the future. Since then, we have gained considerably more clarity and have confirmation that we were fundamentally correct in our assessment of the market. That clarity allows for more granular insights on how we expect this market to unfold, the prescribed best practices to manage and avoid the downside and position for the upside that will follow, and the likely evolution of the real estate funds industry.

For most fund sponsors (or general partners, “GPs”) and investors (or limited partners, “LPs”), the picture is not pretty. While GPs and LPs have endured considerable pain, we believe there is much more to come before we return to stabilized markets. At the same time, savvy investors with the financial and decision-making latitude to execute will enjoy one of the best investment opportunities in their lifetime. While we have heard these platitudes before, we will present why we believe this statement to be true today.

Bottom line, we see the following as the primary trends:

• The real estate sector has not yet reached bottom and will not until perhaps late 2010 or early 2011, with capital markets “normalcy” returning perhaps by 2013.

• No new development will materialize in the foreseeable future.

• New acquisitions will occur at discounts to replacement cost, many at deep discounts depending on the physical condition of the assets and leasing.

• The downturn will be significantly deeper and worse than the 1980s/Resolution Trust Corporation (“RTC”) crisis; many fund sponsors will restructure or disappear. And like the RTC era, successful groups will persist and new groups will emerge, with some of the most successful teams taking full advantage of these market dislocations.

• Investors will return to an emphasis on fundamentals and a focus on operational expertise; initial strategies will include debt repurchases, asset rehabilitations, releasing, debt restructuring, acquisition of fund interests or general partnerships, etc.

• There will be attractive investment opportunities — in direct investments and secondaries — but investors will need to focus on fundamental asset valuations and stable teams capable of executing on operational business plans to achieve the return potential, since this will take some time.
• Recapitalizing or restructuring existing portfolio assets may represent the best near-term risk-adjusted investments — achieving high current and overall returns via senior securities in quality assets. Outstanding returns will be dependent on stable, focused managers to execute the assets’ business plan.

• Building positions via the secondary market with surviving and thriving managers with stable teams that are unencumbered by troubled legacy assets may be especially attractive. These managers will be able to capitalize on “dry powder,” restructure legacy and new assets to successfully see through those business plans, and be best positioned in the next fundraising cycle when the opportunity set enlarges.

• Inconsistent government policy, low interest rates and natural inertia will delay real restructuring, foreclosures, and resales. This will make workouts easier in the initial phase of the recovery as lenders will allow owners to pay reduced debt service despite reduced Net Operations Income (“NOI”). As the cycle continues and assets with insufficient NOI to support senior debt create wasting assets, expect to see larger scale take backs and aggregated portfolio sales by lenders rather than lots of one-off sales.

• Investors will revisit the structure of the LP-GP relationship in all investment formats. For larger investors, separate accounts or other structures perceived to offer increased control and reduced expenses may become more important — but history shows that structure alone will not drive returns or eliminate risk. Ultimately, alignment will be redefined to address the problems that arose during this last cycle.
Overview

More than in any other alternative investment sector, the opportunistic real estate sector stands to be impacted by the most significant change and destruction. In no other sector of private equity — venture, mezzanine, buyouts, special situations, or infrastructure — will the detrimental effect of leverage cause so much pain and value decimation. These forces will cause near and longer-term restructuring of thinking, investing, and the fundamental relationship between LPs and GPs. It will also create the greatest investment opportunities since the RTC, and likely far greater.

The most immediate impact will be the evaporation of equity and subordinated debt followed closely by fund sponsors — something not seen in recent downturns in other sectors where fund structures (10-year lives, ongoing management fees, etc.) allowed many funds with no prospect of raising another fund to live on for years. Unlike buyout operating companies that can reduce expenses and shift business strategies, or venture investments that are typically not highly leveraged, real estate assets are fairly inflexible and have less liquidity. They have the positive attributes of core assets: stable, long-term leased, quasi-monopolistic income-producing machines. Those attributes also make it difficult to reposition in response to dramatic shifts in market conditions. For value-added real estate investments, where investors seek shorter-term repositioning of these assets to generate capital gains, current market conditions have taken away both the cash flow engine and the likelihood of capital appreciation for assets that failed to reach stabilization.

When aggressive leverage is added to the equation for intermediate-term or value-added real estate investments, operating flexibility and bottom line performance quickly erode or disappear in a declining market. The consequence is often a complete destruction of equity and a binary loss for the investor. That is the state of play for most of the transactions completed from 2005 to 2007. The following multiple factors collided in a “perfect storm” that fueled the decline:

- Aberrantly and excessively inexpensive issuing of abundant debt when rents were stronger and could justify growth projections that now seem remarkably optimistic;
- Followed by an economic malaise resulting in declining rents and increasing vacancies;
- Resulting in declining “real” values but more aggressive property auctions;
- Creating an environment for equity and debt investors to employ unrealistic underwriting assumptions for occupancy and rental rate growth.

All of these factors meant that investors and lenders pushed the envelope on pricing and loan-to-value ratios. As the debt on these deals matures, losses will be clarified because refinancing, absent a dramatic comeback in the debt capital markets, will remain largely inaccessible for most deals due to decreased values and far more difficult underwriting.

Many fund sponsors will have legacy portfolios comprised of assets nearly all of which are impaired. If so, most or all of the equity invested is underwater with little chance for recovery. It will take time for the debt to come due and for many lenders to take the assets back instead of “extending and pretending.” This condition will be exacerbated by a persistently low interest rate policy in the U.S. and Europe. But the reality is obvious today: there will not likely be
recovery of equity nor will there be a follow-on fund for that fund sponsor, if a majority of the portfolio is similarly impacted.

Typical leverage structures will preclude meaningful flexibility, resulting in fund managers losing the assets to the lenders, unless they can find new equity to support a restructuring. Given the state of most investments post-2005, that will be difficult, if not impossible to achieve for many, as the asset values are significantly less than the senior debt.

The upshot of all of this is a new reality: a limited number of fund sponsor survivors, few unimpacted by legacy portfolio problems, clawbacks, team and other issues with which to contend. This instability and paralysis will play out over the next few years during what we believe will be one of the best real estate investment windows in recent history. As a result, the surviving, stable sponsors will have the world as their oyster for the foreseeable future, until the capital markets recover and look to take advantage of the extraordinary returns to be generated via distressed investing as the market restructures.

Given all of this, we expect to be into 2013 before a return to any kind of normalcy in the commercial property markets occurs, with stabilized debt markets, normalized transaction volumes and market fundamentals, and a return to more regular real estate investment allocations by investors. This real estate recovery is likely to mirror the broader economic recovery that will assist in supporting real estate demand fundamentals.

Part of the purpose of this paper is to identify the attributes of survivors so that investors can affiliate capital with this smaller universe of investor/operators capable of capitalizing on the early recovery cycle. Based on our analysis of prior post-recessionary cycles, we believe that the early period of the recovery (when the recovery gains clear momentum) will offer exceptional returns, fueled by restrictive equity capital funding from a small universe of stable and market savvy managers.

As a result, our aim for this white paper is to provide the following:

• A sober look at where we are, have been, and are likely to be in the real estate markets for the next three years;

• Our analysis and recommendations for best practices for current and future portfolio positioning;

• A discussion on how to identify the future winners to back to best capitalize on the opportunities in the early part of the recovery; and

• A broader discussion of the implications of this downturn on investment structures.
Where Are We?

These are murky times for prognostication. As far as looking backward at the value of investments already made, the metrics driven by FASB’s Topic 820 (formerly FAS 157) for U.S. real estate opportunity funds that were supposed to provide clarity and transparency are still in the process of being amended long after their supposed final implementation. The proposals on Class 3 assets, which include investments without a clear market value such as those held in private equity real estate funds, are the focus of the latest debate and regulatory comment period, but still do not provide firm guidance.

On October 30, 2009, agencies including the Federal Deposit Insurance Corp., the Federal Reserve, and the Office of the Comptroller of the Currency, provided guidance for bank examiners and financial institutions working with commercial property owners who are “experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in selling or renting commercial properties.” The guidelines made clear that banks can keep loans on their books as “performing even if the value of the underlying properties have fallen below the loan amount. The purpose of these guidelines is clear: to encourage restructurings, as opposed to taking losses, typically without the infusion of new equity. “Restructurings are often in the best interest of both lenders and borrowers,” the guidelines point out.

Many sectors of the debt markets have been effectively shut down for most of the past two years, providing little opportunity for any meaningful financing activity. This has resulted in a distressed market that no one feels properly reflects “fair value” (i.e., only distressed sellers would sell in this market). The result is an effective deferral to fund managers to establish value with no clear standards for how it can be done. The rules changed from the lower of cost or market value to a mark-to-market standard that introduced significant uncertainty when the rules were suspended to avoid balance sheet meltdowns for many of the largest financial institutions in the U.S. and Europe.

At the same time, the public real estate markets were quick to slash the value of real assets. As shown in Chart I, after increasing substantially from 2000 through 2006, the global FTSE NAREIT 50 (heavily weighted towards the U.S. market) began to decline at the beginning of 2007 then plunged in September 2008. From peak-to-trough, the index declined 70%. A loosening of the IPO market in the spring of 2009 allowed certain of the largest REITs to issue new capital, lifting the index off the trough but leaving it still 43% below peak values as of September 2009.

During this same period, we witnessed most real estate opportunity funds showing only modest value impairment prior to 2008. It was really only in the last quarter of 2008 that managers began to report material write-downs in their portfolios. These marks represented only about half of the peak-to-trough value write-downs reported in the public markets. Confusion over how to apply Topic 820 to illiquid assets in a distressed market sector has meant that fund managers have been slow to release updated market values.

Opportunistic fund sponsors typically employed higher leverage (65%-75%+ on average) compared with the typical 50% at their public counterparts. Leverage in a declining market is a value loss magnifier. If the value impairment for public companies averaged 70% peak-to-trough, the value loss for opportunity fund assets as an asset sub-class should be greater. Thus, we believe that there is significant further devaluation to be reflected in opportunistic fund assets as they are marked-to-market to more closely reflect public company values.
As noted in Chart I, REIT values have risen off their trough values. This primarily reflects a recapitalization of balance sheets of public companies through the issuance of over $19 billion of new equity raised in response to liquidity seeking public market exposure and REITs looking to de-lever their balance sheets or stockpile cash for distressed opportunities. This value recovery has not and likely cannot happen for most opportunistic real estate fund assets, given the decimation of equity in most deals and the inherently illiquid character of these assets.

Is the failure to reflect this larger value decline because fund sponsors are unscrupulous? That may be the case for a few. More likely, the reality is that there is so little predictability in the rules of engagement today that these sponsors can properly claim that they just do not know, and as a result, do not want to reflect valuations that are “too” negative. In the absence of lenders forcing restructurings or take backs, there is no real impetus to recognize losses today; instead, all parties can still express hope and delay the inevitable.

The following is an example of what has transpired with a majority of assets in recently created legacy portfolios:

A property acquired in 2007 for $100 was financed with 70% senior debt and 15% mezzanine financing. The asset today is “worth” $50 and is clearly underwater. But the senior debt was covenant-lite or covenant-free — so, there is no immediate pressure to deal with the asset until sometime well into the future. All of the parties know that the asset is impaired.

The fund sponsor does not want to give up hope of preserving the asset, but it has to wait for the debt to mature to get the lender to the bargaining table. The lender has no incentive to deal with the matter proactively as long as the borrower is paying current debt service. It has plenty of other problems. Worse, the lender lacks regulatory clarity on how to deal with
real estate owned ("REO") on their balance sheets. If it takes the asset back, it might have to reserve dollar-for-dollar the value of the asset as it holds it on its books.

On the other hand, the lender is concerned that the fund sponsor will not properly oversee the asset as capital improvements are delayed, tenants are not backfilled, taxes not paid, etc. The fund sponsor is focused on other assets where he still has upside. The lender is further incentivized to delay action in hopes that there might be another federal bailout program to help ease the impacts, or that the economy and hence, real estate values may recover. Everyone is motivated to do nothing absent a current threat of loss (tax liens, etc.). With the increased risk, magnified by persistently low interest rates, the asset will slip into waste.

In this example the fund sponsor may report some value impairment to its LPs — 30%–40% on average based on recent quarterly reports we have seen. Some will cite REIT yields in the sub-4% range as support of improved valuations. Our view is that these REIT yields more clearly reflect investors’ perception of distressed buying opportunities for the REITs and not an indication that investors are satisfied with that level of return on equity from current portfolio holdings. Therefore, the reality that many private equity real estate assets have no remaining equity value remains unrecognized by most GPs and veiled to most LPs today. The value recovery prospects will continue to wane as market fundamentals continue to slip (eroding occupancy and rents in a weak economy, and increasing yield expectations for buyers) and capital markets for refinancing continue to be limited for the foreseeable future. As debt maturities in 2010 and 2011 arrive, lenders will have to act to protect against further erosion of value, and the assets will ultimately be taken back and resold to the market or restructured with new equity where the senior debt is subordinated, creating a hope certificate for the lender.

**What Does the Lack of Valuation Clarity Mean for Institutional Investors?**

Given the lack of valuation clarity, we believe investors should consider the following:

- For your internal planning, we urge you to take a realistic view of the value of your portfolio. If your portfolio is concentrated with funds that invested heavily in the most impacted vintages, you should take additional value impairment (formally or informally) to reflect reality and proactively position your portfolio for the future.

- As you deal with your GP relationships, it is the right time to have serious discussions with those who are still carrying portfolios at values significantly in excess of current reality. It is a great opportunity to assess the integrity and probity of your partners as a reference point for future investing. This is a matter of trust — a critical underpinning of blind pool investing. A failure to take aggressive value hits early raises questions of intelligence, judgment, and reliability. If investors broadly expect large devaluations, GPs can take losses with relative impunity and then enjoy the benefit of future outperformance, should it occur.

- Valuations will continue fundamentally to be tightly tied to the reopening of the capital markets. The longer this takes, the greater the likelihood of further equity erosion or loss. When capital markets do reopen and refinancing becomes viable, values could rise across the board — but this is heavily dependent on interest rates, resulting cap rates and employment
growth. Easing capital markets will certainly give lenders more courage to take back assets where equity value is gone when they can see a clear path to sale at a price that meets or exceeds their internal valuation. Only when such market conditions are present will there be sufficient volume and substance in transactions to start to imply “fair value” of assets.

**The Great Recapitalization/Restructuring Opportunity**

Several pundits tell us that they see the greatest near-term opportunity in real estate investing in the refinancing or restructuring of assets. They expect new real estate debt and equity funds to emerge to provide new capital to fund sponsors and other owners to enable them to restructure current deals. We agree on the magnitude of the opportunity. We are not sure that we agree about the form it will take.

Why will this opportunity arise in the first place? Can fund sponsors get the needed capital from their uninvested capital pools or from their LPs who have a shared interest in protecting their investments? The answer, as discussed below, is generally “no.”

For those GPs fortunate enough to have uninvested commitments and still be in their investment periods, their LPs have said clearly to them, “We do not want you investing good money after bad. While you might be able to justify doing so, we do not have the time nor the resources to figure it out.” So the consistent message from LPs has been, “If you invest new fund capital in legacy deals, do not bother coming back to us for your next fundraise.”

For some GPs, the prospects for raising a new fund are so bleak that there is little downside to ignoring their LPs and calling the capital, as allowed under their Limited Partnership Agreement (“LPA”), on the theory that great performance will buy forgiveness. That is a risky strategy that encourages “swinging for the fences,” which has the concomitant risk of striking out. While we have not seen a lot of this yet, the lenders have yet to exert force to take back assets. When that happens, GPs anxious to save perceived equity value might call the unfunded capital commitments.

Alternatively, GPs outside their investment period or having fully deployed their capital could request additional capital from LPs on a non-discretionary basis to protect assets where they believe equity value remains. Again, the answer from LPs has by and large been “no.” The rationale from LPs is slightly different. First, most LPs are capital constrained, bumping into or exceeding their portfolio allocation for real estate as private allocation valuation adjustments significantly lag the public components of their portfolio (the “denominator effect”). While this has been mitigated somewhat recently by the meteoric rise in public securities, it remains an issue for most institutional investors. Further, given the massive value losses reported in most institutional portfolios, it is not politically popular to propose allocating additional capital to opportunity fund managers today.

Finally, most LPs lack the resources required to evaluate the recapitalization opportunities presented by these GPs. The investment decision requires, at a minimum, reaching a conclusion that the asset value supports the finding that there is equity value to protect. Then, investors have to determine that the return on this new equity justifies the investment (relative to other similar proposals and other alternatives across their portfolio) and that the team is capable and focused enough to see through the business plan. Even if investors had the capital and the
resources to get that far, most lack delegation for a direct or co-investment program and simply
can not make the investment in the first place.

All of the foregoing pales in comparison to the potential conflict of interest issues that result
when the economic structure of a deal gets recut via equity infusion by some but not all LPs, the
dilution of non-participants, and the restructuring of the economic incentive deal with the GP.

The complexities surrounding new capital investments in legacy deals by existing parties are
considerable. As a result, it is likely that these opportunities will be diverted to third parties
with the expertise and objectivity to properly evaluate them. Certainly, this is more likely in the
current environment than annex funds, where some LPs provide discretionary capital to GPs
to support additional equity infusions or recapitalization capital for legacy assets. We have
seen some annex funds get closed, but these usually include significant pre-identification of
the assets to be supported, materially diluted (or subordinated) economics for the GP, detailed
business plans, and a standby fee paid by the GP to annex fund LPs prior to capital being called.

Given the obvious need for third-party capital and involvement, we are bearish on the prospects
for debt funds to participate in this restructuring of legacy portfolio assets. As stated above, a
pre-condition to any such arrangement is sufficient equity value to justify a refinancing of the
deals and induce these lenders to come to the table. Most deals we see today are underwater,
meaning that there is no equity to protect and, as a result, no incentive for the fund sponsor
to infuse new equity to recut the loan structure. Ultimately, rather than being restructured,
we believe that many of assets will eventually be taken back by lenders and sold in portfolios,
resulting in a more traditional equity-oriented investment opportunity akin to the RTC experience
of the 1980s. The reasons that restructuring will be viable for many assets in this cycle, unlike
the RTC cycle, are (A) much less over-building, (B) the greater availability of equity capital, and
(C) persistently low interest rates perpetuated by government policy.

Even where restructuring is a viable possibility, we are concerned that the magnitude of issues
most GPs have in their portfolios will be a significant disincentive to third parties jumping into
the fray. We anticipate reduced bandwidth to manage and operate assets that have been
allowed to fall into disrepair and underperformance. As economically rational beings, GPs will
triage their opportunities and focus on those with the best prospects for the highest returns and
not focus on those that are challenging or unlikely to yield great payback. A GP’s capacity
to apply its expertise will be diluted by distractions that include team departures, clawback
issues, tax issues and other legacy portfolio issues that collectively will increase the risk that
they will not be able to carry out the business plan for their portfolios that is being funded by
a new capital infusion.

Consequently, the independent provider of new capital will insist on additional skin in the
process from the GP, to ensure focus on the asset being restructured, and a disproportionate
share of the upside in repositioning the asset to derisk the situation as best it can. Ultimately,
there may not be enough incentive left for the already stretched GP to properly execute on the
restructured plan. Third parties and lenders alike are likely to conclude that a new manager
with a clean slate and clearer alignment is better positioned to execute on the new business
plan successfully.

In those circumstances in which there are (A) sufficient equity to protect and (B) a focused team
to carry out the business plan, the investment opportunity to provide new capital is exceptional.
Given the constrained equity and debt capital from existing investors, new investors can expect high current and overall returns, and superior risk mitigation in the form of senior debt securities. This represents perhaps the best near-term investment opportunities for savvy investors with the resources and capital to execute.

**Follow-on Financing Opportunities: Implications for Investors**

What should LPs do now in the face of requests for new capital or to approve allocations of unfunded commitments from GPs seeking to support legacy investments? We strongly urge getting policies and procedures in place to prepare for this impending flow of requests for additional equity investment.

If you have not already received this type of request, you will soon. If you have a policy, you will eliminate the need to be reactive to a flurry of requests. If you want to participate in funding follow-on financing for your managers, you will need a process to evaluate proposals on their merits. If you do not have experienced, direct real estate professionals on staff, you will need to retain third parties to help you establish underwriting standards, return requirements, and risk assessments at the property and GP levels. You may establish a policy that you simply do not participate in such financings. In any event, you should insist on full disclosure of all transactions in which a GP enters for new investment into legacy assets to ensure that your interests are properly respected by the GP, since these will surely include a dilution of your legacy position and a new economic deal between the GP and the new capital source.

If you do not have delegated authority to make such investments and you want to do them, you will need to obtain it. A majority of the investors with whom we work lack delegation outside of traditional fund investing. Even if you do have such authority, depending on the political environment in which you operate, it may make sense to reaffirm support for this activity with your board and CIO.

We expect to see a number of new funds formed to act as the objective third party to evaluate these opportunities and to invest up and down the capital structure. Investors will need to evaluate the managers of these funds carefully as few will have the requisite combination of applicable and attributable records of performance, operational experience, and a lack of other distractions. While there is abundant analytical talent available today, that expertise will need to be married with competent operational expertise and an intimate understanding of the fund manager space to evaluate and de-risk the GPs who will execute the business plan. That will require an inside knowledge of that market, coupled with an aggressive asset management program and team to monitor and manage the execution of the business plan.

For new fund managers focused on providing follow-on or restructuring capital, the ultimate recourse, should the GP fail to execute the business plan, is foreclosure. If these new fund managers lack the management capabilities, or a proven arrangement with others who have that capacity, taking over the asset will be an empty threat to the GP. Taking over the asset could also be a pyrrhic victory, if acted upon. The lack of expertise and capability to take over and turn around distressed assets on the part of new fund managers providing recapitalization equity and debt poses a serious risk to performance, as some of these assets will likely require post-investment intervention and operational expertise.
Finally, while it may seem a perverse outcome, it may be better for the LP to have the GP simply give assets back rather than trying to protect marginal remaining equity in deals for the following reasons:

1. The time and attention required to restructure deals can be immense. Inevitably, that will be time taken from other portfolio assets that need focus to protect and expand equity value.

2. If the GP structures an aggressive deal with the new capital to be well compensated should the asset achieve certain milestones, it may cause disproportionate focus on that deal so that the GP can achieve personal benefit, to the detriment of you and the rest of the portfolio.

3. Depending on the condition of the rest of the portfolio, any dilution of focus away from a small number of value-driving deals in the portfolio might be the wrong answer.

4. For a surviving GP, the focus on assets with no remaining equity value comes at the cost of missing attractive new investment opportunities.

At the end of the day, the GP needs to triage the portfolio in light of available economic and talent resources relative to projected returns, the same way we recommend LPs do with their portfolios. The GP should present this triage analysis to its LPs together with the revised business plan and a commitment for execution and then frequently report on status and developments.

Where Will Restructuring Opportunities Be Found?

The U.S. and the UK represent the greatest near-term market opportunities for both restructuring and buying opportunities for assets that are repossessed by financial institutions and resold in portfolios. We expect to see a very slow market recovery in traditional equity investments, even in stabilized, well-tenanted, high-quality assets because of tight debt markets and uncertainty about future cap rates. Trophy assets may avoid this to some extent as sovereign wealth funds and other very well-heeled investors buy these assets at seemingly discounted prices. The U.S. and, to a lesser extent, the UK have historically been more willing and able to take the near-term pain and restructure legacy assets to get back to work on new investments. In the current cycle, the UK may actually be taking a lead in this regard. Markets like Japan, Germany, and France have historically persisted in denial for protracted periods, delaying and in some cases never addressing underlying asset values and the necessary restructuring to return to healthy and robust real estate and debt markets. But in this cycle, France and Germany were impacted less by steep value run-ups and were mostly untouched by the subprime/Commercial Mortgage-Backed Securities (“CMBS”) debacle, arguing for more moderate value adjustments. Still, Western Europe will likely follow the U.S. and the UK in rationally re-pricing assets and accepting the pain necessary to restructure and re-price these assets, while generating attractive investment opportunities through that process.

1. This analysis ignores the possibility that GPs, with deals where the equity value is gone, may be able to purchase the underlying debt on those deals at a discount great enough to “recreate” equity value. That strategy may also be viable, but as with other strategies discussed above, it too is dependent on the willingness of lenders to take losses.
At least for the foreseeable future, we see the U.S. as the best real estate risk/reward investment opportunity because of the attributes of greater transparency; modest political, governmental and cultural risk; and a highly visible need for new equity and debt capital to restructure existing assets.

While there may be opportunities in the emerging markets, there are dangers as well. Asian markets are currently surging in values, as detailed in Chart II below, even more strongly than in the developed markets. The dominant factor underneath this rise is the Chinese market, where government stimulus programs have driven both GDP growth and market demand. Experienced Asian investors are worried that the economy is overstimulated and that, along with weakness at Chinese banks, this will create problems for the future.

In the face of broader economic market issues, most investors recede to their home markets where they are more knowledgeable and comfortable. We see that process and focus continuing well into this recovery, thereby muting most near-term non-domestic recovery participation. We expect to see that change considerably as markets recover and investors increasingly rotate investments into higher growth markets, which we expect to see likely in 2012 and beyond. When that happens, expect to see the continuation of the rotation of capital from U.S. and European investors to Asia and Latin America (especially Mexico and Brazil).

**Chart II  EPRA/NAREIT Asian Indices, January 2000 to September 2009**

Source: Private Equity Intelligence, Private Equity Analyst, Probitas Partners
The Great Secondary Market Opportunity

Many investors, especially foreign investors who do not have a large portfolio or any portfolio of U.S. real estate assets, believe that the current market conditions are ripe for building or expanding their portfolio via acquisitions of secondary fund positions.

We agree that there will be bargains in the secondary real estate fund market as the cycle continues. As discussed above, buying real estate secondaries is quite different from buying private equity secondaries. Not only do real estate secondary investors need to determine underlying values in the face of huge valuation uncertainty and unstable market conditions, but buyers also have to pierce the more opaque veil of GPs to determine the real condition of all their legacy portfolios (not just in the fund the buyer is seeking to acquire), the health and stability of the team, and related issues like GP clawback exposure, proper allocation or reallocation of fund economics to maintain team cohesiveness, etc. We believe that many of these variables will not be truly known until the market cycle is more advanced.

The greatest secondary opportunity in our view is to strategically and selectively acquire low basis positions in the surviving and thriving managers (see discussion on attributes on page 18) of tomorrow both to (A) capitalize on their ability to invest successfully in the current recovery, and (B) invest with them via recapitalizations of quality assets in their legacy portfolios (and perhaps others) and form an important rapport to enjoy a seat at the table for their future funds. Successful selection of targeted GPs in which to build positions may help investors deploy the restructuring capital with the best teams that we also believe to be one of the best opportunities for the foreseeable future.

Investors need to approach this exercise with care. Buying assets on the cheap alone will not ensure the hoped-for returns, if the assets are poorly managed by unstable and distracted teams. Worse, if the team and thus the fund implode, a secondary buyer could be looking at significant losses on what was thought to be a risk-mitigated strategy.

Lastly, secondary buyers of real estate fund positions need to gear up for a much more active post-acquisition role to preserve their investment and to capitalize on the upside. Specifically, as discussed elsewhere (regarding requests for additional equity from GPs), secondary buyers need to be prepared for foreclosure notices, requests for use of unfunded capital to protect legacy assets, and the possibility of fund restructurings.

Best Practices Today to Position for Tomorrow

The best practices that institutional investors should follow today are not the same as two years ago. We suggest the following steps be taken:

Continue and Further Your On-Going Planning and Strategic Thinking. As the capital markets have begun to stabilize following over a year of turmoil not seen in most of our professional lives, investors are re-visiting their modeling, allocations, and relationships. Commercial real estate, being an economic trailing indicator, will almost certainly continue to suffer as an asset class in the near-term. As a result, this is a good time
to re-assess strategy and direction. Our recommended action plan in this environment is multi-fold:

- **Get ahead of where you are.** Working through multiple scenarios of capital calls and realizations, along with working with your senior leadership to determine what levels of flexibility and capital you have, will enable better decision making as events unfold. As part of this process, determine what, if any, holes should be your first priorities to fill with dry powder; and

- **Triage existing manager positions.** Assess your existing managers with an eye on current portfolio positions using conservative valuation methods. This should help you clarify your strategic plan for existing managers, determine the managers you want to support to preserve long-standing relationships, retain best performers, and capitalize on those best positioned in the current environment. This necessarily requires determining the managers who you would likely not support even in the absence of capital constraints. Finally, rank every fund until you have established your priorities for where capital is to be applied in the event you have to make tough choices. This should be an ongoing, dynamic process as you gain clarity on your managers’ teams and portfolios over time.

**Use Liquidity Management as a Permanent Portfolio Management Tool.** The secondary private equity real estate market continues to emerge as an important tool for addressing over-allocation and cash management issues in real estate portfolio management. This strategy offers flexibility and options, previously not available in this asset class, that include the following:

- **Plan for liquidity.** While investors may decide not to access the secondary market to relieve allocation constraints, to free up cash to meet capital calls (instead of taking it from the fixed income or public portfolios), or to redeploy proceeds into what are likely to be better vintages (2010–2012), prudent investors will want to know their options on an ongoing basis by monitoring secondary market activity. Those who choose to transact via the secondary market should proceed in the following manner:
  
  - Clearly understand the current state of the real estate secondary market;
  - Develop an understanding of how specific positions in their portfolio will be received in the market;
  - Clearly establish goals for their liquidity efforts and be highly confident that they are achievable; and
  - Ensure that their institution (e.g., boards, CIOs, etc.) understands and is prepared for such an undertaking in terms of anticipated pricing and resources.

- **Position for success.** Staffs that lack current delegation of authority to sell or buy real estate fund positions will want to obtain that delegation of authority to be able to capitalize on market opportunities and challenges. Smart investors will seek the ability to sell and buy secondary positions.
Probitas Partners has developed a proprietary analytic model to help you understand the point of indifference between holding your current portfolio positions and selling all or a portion of it at a discount to create current liquidity or to redeploy capital into future investments. This model is available upon request.

Make Sure Your Leadership Is Well Informed and Aligned. Private equity real estate has represented a flat or outperforming sector in the alternative asset class since its inception. Many boards and beneficiaries have grown accustomed to this perceived stability relative to other asset classes in market downturns.

Current market conditions, coupled with changing valuation rules, present a very different paradigm for private equity real estate. These changes dictate a very different playing field than what most investors have seen. To be successful in this environment, investors should continue to educate and obtain on-going agreement internally about how to address this investment backdrop, and make sure their beneficiaries are informed about this new reality. Alignment and support from CIOs and boards will be critical to successful investing in the near-term.

Be Proactive. Current market dynamics do not represent a brief bout of turmoil, but do represent the makings of a unique investment opportunity, if managed properly. The market is likely to experience a protracted period of volatility and stagnation. Real-time market knowledge and continued iteration of scenarios and best responses are part of a positioning process, when coupled with an informed investment team and capital to make well-timed and informed investments.

While we are not advocating taking many new meetings with managers to whom you are unlikely to commit, new fund sponsors with relevant strategies can provide an important source of market reconnaissance that can aid you in the process of assessing the market and your portfolio. As the markets improve and liquidity returns, you will want to be well-positioned to take advantage of those developments. As an active market participant, you will want to keep the lines of communication open with trusted industry sources, peers and your best fund managers and have the authority to “pull the trigger” when the time and circumstances are right.

How to Identify the Likely Winners of Tomorrow

A recent white paper by the Partners Group compared the top 15 real estate managers in 1990 with those cited as the best by PERE magazine in a recent article and concluded, based on its definition of survival, that only 30% of the 1990 vintage groups survived that 20-year period. Unfortunately, that has been the nature of the real estate industry since the beginning of time.

While that reality has profound implications for investors who seek to align with managers for the long-term, for opportunity fund investors, it presents an ongoing opportunity to outperform your peers. If you are willing to assess the market constantly, identify the best managers and affiliate with them on a dynamic basis, you are likely to generate outsized returns.

To do this, it is critical to debunk some myths, focus on the reality of the market, and examine how to find and invest with the winners. The notion of investing with a fund sponsor as an
unchanging, long-term relationship is an unrealistic aspiration, with limited chance of success in the real estate fund market, as people and institutions change over time.

What does this mean to you as a fund investor? You should recognize that the universe of real estate GPs is dynamic and that it is likely that many of your current, favorite GPs will not be around five to ten years from now. As a result, while you should always aspire to build long-term relationships, you should also be pragmatic and recognize that opportunistic fund investing requires a constant effort to identify, cull and re-cull the next best fund managers.

Most real estate funds are extensions of the person driving the fund, and few morph in ways that enable them to become truly institutionalized. Charisma of the fund manager is often what drives the fund’s success. The single-personality led fund is also often the limiting factor that causes the organization not to make it to a more durable structure. If you recognize that, and understand the life cycle of these organizations, you can become a far more successful investor.

The best indications of future success are past success. While no guaranty, the persistency of success coupled with recognized patterns of successful behavior across managers, offers the best probabilistic assessment of managers’ likely future successes.

An investor’s approach will be especially important in the current difficult environment where few active managers over the past three to five years will have achieved positive results. The number of viable, new investment-focused managers will be quite limited. These will be the managers with the necessary resources and capital able to take advantage of the best opportunities in what we expect to be a very attractive market. Affiliating with those emerging managers early will give investors the best chance of capitalizing on the market opportunities and retaining their position in the GP’s future vehicles as new capital surges to fill their future funds as a result of historical success. The payback for best manager selection is substantial.

The classic historical quantitative analytics most investors perform to identify persistence in successful investing will only be marginally helpful in a market where nearly all managers will have nominally poor performance from the past cycle. This data still provides some help in terms of experience, team durability, adherence to strategy, etc. Managers who have achieved stellar performance in this cycle should be considered over new managers, because of their demonstrable insight and proven restraint.

After 20 years (on average) of evaluating alternative managers, Probitas Partners’ senior team continues to evolve a proprietary evaluation tool for our assessment. We incorporate quantitative and qualitative attributes that are evaluated and then scored using a weighting system that is continuously adjusted to reflect the importance of the variables depending on improving information, changes in the market, etc. The weighting of these variables can be adjusted to reflect the importance of certain criteria to each investor (or as with the last two variables below, to determine the investment attractiveness of a GP from a secondary and recapitalizing perspective). Our qualitative assessment looks at a larger number of variables and asks questions that include the following:

- **Team Stability.** Concerns or issues about internal conflicts, disproportionate carry splits, decision-making processes, no remaining incentive due to no carry value heighten risks of team departures, clawback exposure, and other issues.
• **“Long-term” Orientation.** Significant and realistic early value write-downs. Clear communication with investors regarding debt and counter-party risks in portfolio. High-quality, detailed, transparent communication with investors. Restructuring of the fund economics, if needed, to ensure team continuity in the face of changed economic performance.

• **Diligenceable Discipline.** Clear evidence of historical pipeline of deals where the GP maintained pricing discipline and pursued deals but ultimately passed because of pricing and/or terms. Evidence that in a “heated market” the GP realized on the market conditions to sell assets into the market even at the loss of continued management fees.

• **Operational Competency.** The GP demonstrates on board and reliable historical capabilities to impact operations, grow NOI, dramatically cut costs and/or reposition assets, whether through professionals on team or durable relationships with third parties.

• **Institutional Memory and DNA.** Members of the team have multi-cycle experience from the RTC period or direct experience in distressed markets and can bring that perspective and healthy pessimism to bear on their decisions to purchase, manage, and sell distressed assets, or can recognize when it is too early to invest even when things look cheap relative to recent peaks but not long-term realities.

• **Capacity and Legacy Issues.** Team depth and stamina to deal with legacy issues and still proactively invest new capital. How bad are the legacy issues? How much of a human resource issue does it pose? How long will it take to unwind or rework? This includes a clinical evaluation of remaining investment period and likely deployment, refinancing and counter-party risks in portfolio, as well as potential conflicts of interests at the asset and/or partner level.

• **Likelihood of Secondary Positions in the Fund.** Given the composition of existing LPs, what is the likelihood of available positions coming from those investors to the secondary market?

• **Likely Portfolio of Follow-on Investment Opportunities.** How many legacy assets will (A) have protectable equity value, (B) will need refinancing in the next two to three years, and (C) will provide the opportunity to selectively co-invest with the fund at more attractive negotiated terms (no or moderated fees or promote) in deals that exceed covenants?

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**The Reversion to Separate Accounts — Back to the Future and the Illusion of Control**

A number of the largest U.S. pension funds are reconsidering how to invest their real estate allocations. Several have recently announced they are abandoning fund investing and are returning to separate account investing as a means of regaining more control over their investments. They believe they can tailor investment programs with individual managers to meet their requirements for risk and returns, instead of only being a taker of fund structured products where they lack the ability to dictate strategies, limitations, or terms.
The premise supporting the separate account theory is that large institutional investors can use their size as a benefit, rather than of having it used against them as GPs did when they had over-subscribed funds. GPs capitalized on large investors who sought larger allocations in order to more efficiently deploy their capital and were able to dictate terms. In that environment, GPs enjoyed disproportionate leverage given limited supply and excess demand for their product and services.

While pension funds will get more control using a separate account strategy, there are a number of lessons to be learned from the 1980s, when it was the dominant investment structure for U.S. pension funds. The following deserves careful study as large institutions look ready to wade back into separate account formats:

- **Inherently Negative Manager Selection.** While there will be abundant talent available for these separate account teams, they will be available because of their inability to raise discretionary capital. Managers who can raise discretionary capital are at the top of the food chain of third party capital management. They get there because of performance. Blind pool capital that allows the manager the greatest discretion to generate performance, and the greatest competitive ability to win deals, is the prize for proven success.

In most cases, non-discretionary managers are there only because they cannot raise discretionary capital. De facto, that reflects a second-tier manager, or an investment strategy, where alpha is less dependent on the quality of the manager. In other words, a separate account is more appropriate where core-like returns are sought, because they require less alpha, and therefore the manager matters less. But, if an institution seeks to best execute value-added or opportunistic strategies via a separate account structure, it is **caveat emptor.** You get what you pay for.

If the separate account is not “discretion within a box” — discretion to execute a strategy via deals that meet minimum requirements — but is non-discretionary or quasi-discretionary, it faces even greater risk of successful execution. Ultimately, if a large institution is fortunate enough to find a separate account manager for core-plus, value-add or opportunistic investing who generates exceptional performance, this is likely short-lived, because the manager will ultimately pursue a discretionary fund structure to improve personal economics.

Separate account structures created by public institutions are typically administered via Requests for Proposals (“RFPs”). These are public, competitive processes, often led by consultants that most often restrict participation to industry incumbents. Often those incumbents have the longest records managing third party capital, but not necessarily the best records. Ironically, the best providers of the requested service are often newer teams that fail to meet the artificially high-bar set by the consultant for the RFP. The theory is that by requiring deep benches of experience, the risk of successful execution is reduced. But, as noted above, often while the institution has been investing for a long time, the team responsible for that record is no longer there. These artificial requirements often eliminate the best possible teams in favor of “brand names.”

The other issue with the “brand name” approach is that it concentrates the separate account market in the hands of a few managers. As these managers grow, they have to create
queues and other allocation policies to address the inherent conflicts of how they assign the limited universe of opportunities to their growing account base. Eventually, this becomes overwhelming and investors grow frustrated that they are unable to deploy their allocations quickly (especially in a quickly improving market) or that other investors appear to be getting “better” deals. This reflects the primary concern with the separate account model. Given the highly competitive nature of the business, the only way to increase profits for separate account managers (and to enable high quality team attraction and retention) is to grow assets under management (“AUM”). It is an inherent conflict in the separate account model. This was one of the primary causes for the model falling out of favor — along with the exceptional returns the opportunity funds posted post the RTC era that attracted more capital to the opportunity fund model.

• **Non-Discretionary or Quasi-Discretionary Capital is Inherently Uncompetitive.**

If a manager has to go back to its client for final deal approval, even if this process is fundamentally administrative and the market knows of that requirement (which it always does), that manager will invariably lose competitive opportunities to fully discretionary buyers. It is the reality of the deal market that certainty and dealing with a principal-equivalent carries a premium for motivated sellers.

Deals that make it to a non-discretionary buyer for approval need to be reviewed carefully. In the 1980s, those deals were often the ones rejected by the discretionary buyer community. The seller was willing to endure the risk of delay and the institution not providing the final approval because the separate account manager offered a premium price (read: lower return to the investor) to induce the seller to sell. At the end of the day, the non-discretionary structure achieved the control goal in the 1980s, but often at the cost of returns.

**The Next Big Thing**

Whether the opportunity flow will come from portfolios of assets being sold by lenders or in the form of asset level restructurings, the opportunity will be massive. Massive opportunities need two things to be capitalized upon: (A) massive capital and (B) experienced and properly resourced investment managers. In the beginning of this next cycle, both will be in short supply. While capital can nimbly surge if attracted by great opportunity, the assemblage of experienced and capable talent that has prior experience working together, or at least had some time to prove that the marriage looks durable, will not be so easy to come by.

There are a number of similarities today to the RTC era. It took a long time to recapture the assets and, in that interim period, substantial value was lost as assets were improperly managed, under-capitalized or abandoned. There was insufficient talent at the institutions that took over the assets, resulting in assets being undermanaged and improperly understood. To address this condition and a quickly growing portfolio of assets, the RTC packaged up very large pools of assets with limited data and allowed the market to price them.

The result was that interested buyers had to assemble armies of accountants, attorneys, and real estate operating professionals to quickly assay underlying assets, create financial packages, capital budgets, projections, etc., in order to arrive at a rational purchase price. There was limited equity capital available and a limited number of players capable of assessing such large portfolios in a timely manner. The participants who properly staffed the effort and had access to capital generated unparalleled returns.
The current market conditions appear to be capable of delivering the same level of opportunity—and at a scale in terms of volume of assets that will dwarf the RTC bonanza. This will require finding investors with the experience and resources to properly task the opportunity. Most of the entities that were created by their success with RTC portfolios are either no longer in existence or are themselves under so much stress in their portfolios that they will not likely be able to participate in the opportunity at hand; instead, they will be contributors to it. A few firms have the resources and have retained the culture and strategic orientation to best capitalize on the impending opportunity. Unfortunately, they are exceptionally few in number.

It is our firm belief that those organizations that use the next few quarters to proactively find and assemble experienced RTC era-like talent (i.e., accounting, legal, and real estate operations), and construct systems around that talent, stand to be tomorrow’s clear winners. These entities will have to operate at scale because the magnitude of the asset flow that has to be restructured or taken back and resold is massive. If the past is any indicator, that scale and the barrier to entry it represents will create a small universe of fund managers likely to absorb the lion’s share of capital dedicated to this opportunity. There will be smaller managers who will generate great returns dealing in one-off asset purchases (many out of the larger transacted portfolios) or smaller portfolios from smaller institutions, but the majority of capital deployed and some of the best returns will be done with scale.

The reward for identifying and investing with these emerging victors of tomorrow is that they will lead the way into the next cycle. If the RTC experience is any guide, and we think it is, the next two to three years of working through the commercial real estate asset deleveraging and restructuring will spawn the top firms at the mid-point of the next decade who will capitalize on an unprecedented opportunity for value creation for those investors brave enough and capable of executing before the opportunity is so obvious that it is already past.