JANUARY 2012

Market Commentary: First Quarter, 2012

Our Top 10 (Actually 11) Market Observations for 2012

It has been several months, actually several quarters, since we last distributed a Market Commentary. We would love to ring in the New Year with a prediction about how market fundamentals point to a rosier investment environment in 2012. However, we remain skeptical of the pace of the recovery of the capital markets and property valuations, absent sustained improvements in operating fundamentals and in the face of the global economic environment. We believe that assets are being priced for perfection, considering the relentless waves of conflicts and challenges - the European debt crisis, instability in the Middle East, a lack of political leadership in Washington and in other sovereign capitals and, as we embark upon the New Year, the continuing US budget crisis (as the so-called Super Committee has proven itself to be not so super), renewed threats of Greek default and unrelenting pressure on the European Union.

In spite of all this negativity, there continues to be no shortage of capital for real estate. In fact, the most cheerful note in our songbook is that we have never seen more capital available for real estate. Most of it is in the hands of "responsible adults" and will be professionally invested and managed. This abundance of capital, in our view, provides the underpinning that is sustaining property values for prime assets at levels that are approaching historical peaks (and arguably replacement cost), but which only seem supportable if you are underwriting strong net growth in demand and rents. While we believe that operating fundamentals will eventually improve, paying for future growth today still seems to be aggressive. It is becoming easier to make an argument that operating fundamentals have bottomed; however, the "fat tail risk", which we have previously written about, is a real consideration when factoring in the various potential shocks to the global capital markets. **In summary, we believe that the current pricing of many transactions indicates that buyers are paying for future upside today and choosing to ignore the signs of significant downside risk.**

We have historically maintained an open door to fund managers and property companies seeking advice about capital raising and the opportunities for sourcing new capital or partners around the world. We hear much about unique access, off-market activities, the ability to de-risk investments ahead of the buy, and often times just plain common sense about making money in real estate through hard work. Based on the active dialogue we maintain with managers and the institutional investor community, we thought that we would begin the year by presenting 10 observations about the markets. As always, we welcome your thoughts and look forward to your feedback.

1. **And They're Off** ... This is the first time we can recall that so many of the long-standing opportunity fund managers are in the market competing for capital at the same time (in alphabetical order: Angelo Gordon, Blackstone, Cerberus, Colony, Fortress, Rockpoint, Starwood, Walton Street and Westbrook). This offers a great opportunity for institutional investors to do a true side-by-side comparison. Many of these managers are now approaching 20-year track records. Investors can, and should, study performance - not just aggregate

IRRs and multiples, but also leverage used, dispersion of returns, and attribution (particularly if a manager has experienced employee turnover). We believe that all managers are not created equal and are hopeful that the market (i.e., institutional investors and consultants) will recognize this. We are often left scratching our heads as perennial under-performing managers continue to raise capital, at the expense of new or emerging managers that are better-positioned to generate profits and returns in the current cycle.

2. **Partying Like it's 1999** ... IRRs are a helpful measure of performance, but can be misleading. Managers that have been in business since the 1990's continue to ride the wave of their early successes. Not to discredit a manager's track record from 20 years ago (to the contrary this experience should be considered a major plus), but the markets today are very different from the 1990's. Management teams have evolved or in many cases have turned over, and the "hunger factor" also needs to be considered as many of these managers are playing with house money. The calculation of an IRR, through the effect of compounding, can greatly magnify early performance (see below). Calculating transaction or fund IRRs on a "time zero" basis provides an additional, and arguably better, view of the consistency of a manager's performance over time.

CALC 1 - CASH FLOWS

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	IRR
Fund 1	(100)	15	15	15	250												35.3%
Fund 2			(200)	40	40	40	375										30.8%
Fund 3						(300)	50	50	50	50	550						24.8%
Fund 4									(500)	50	50	50	50	550			10.0%
Fund 5												(750)	0	0	0	500	-9.6%
Total	(100)	15	(185)	55	290	(260)	425	50	(450)	100	600	(700)	50	550	0	500	21.4%

CALC 2 - TIME ZERO

	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	IRR
Fund 1	(100)	15	15	15	250												35.3%
Fund 2	(200)	40	40	40	375												30.8%
Fund 3	(300)	50	50	50	50	550											24.8%
Fund 4	(500)	50	50	50	50	550											10.0%
Fund 5	(750)	0	0	0	500												-9.6%
Total	(1,850)	155	155	155	1,225	1,100	0	0	0	0	0	0	0	0	0	0	10.8%

3. **Where's the Distress?** ... Institutional investors are increasingly skeptical about the prospect for distressed investing. They have been hearing about the wave of distress on the horizon since 2008, but the deal flow has not materialized. In a market where most deals of size are brokered by an agent and numerous investors are capitalized with sizable amounts of "dry powder", there is no doubt that "distressed" deals are being aggressively bid up. Time will tell if these investments perform to underwriting. But we are hearing (admittedly from the losers in auctions) that distressed debt is being bid up to pricing levels based on projected 10% to 12% IRRs. Low multiples in distressed debt are acceptable relative to the risk if coupled with high IRRs and a repeatable investment opportunity; but the combination of low-teen IRRs and low multiples is increasingly less compelling to institutional investors. Moreover, if the manager is outsourcing the "value add" execution to a third-party service provider, institutions are wondering why they need to pay "1.5 and 20" to a manager that, absent a unique sourcing capability, is looking for a pat on the back for being the highest bidder.

4. **Why is Everyone Picking on the Little Guy?** ... Since the market downturn, investors have been very focused on attacking the level of fees earned by managers. We have observed that the brunt of the investor ire has been borne by smaller, boutique managers. This is having the effect of drastically changing the economic model for boutique managers, while larger managers continue to command full fees, and, due to scale, generate high profit margins on management fee income (regardless of performance). Sorry, we are having a hard time feeling sympathy for multi-billion dollar managers that are giving 10 bp discounts to their $200 million investors. But investors should recognize that imposing lower fees on highly capable boutique managers may drive them out of the industry, while the bigger managers keep getting bigger, or at least more profitable. And if smaller, boutique managers become resource constrained or are ultimately driven from the business, will investors be better off only having the option of large fund managers?

5. **Pass the Ketchup** ... One term that has come under fire is the catch-up. If investors have their way, catch-ups will be eliminated from the industry. We can make an argument as to why a catch-up provides an appropriate incentive for a manager that has delivered a cumulative 9% or 10% annual return (particularly in a near-zero interest rate environment). But investors remain convinced that the evil catch-up was the cause of so many poor results. It was newsworthy when Westbrook, an industry stalwart, eliminated the catch-up provision from its latest fund (as reported in Real Estate Alert). This was a bold move by Westbrook, and we predict that other managers will follow their lead. Of course, Westbrook probably figured out that the catch-up can work against a manager, often providing an incentive to sell an asset too early. So Westbrook traded the catch-up for a lower preferred return of 6%. In a world of lower leverage and potentially longer holding periods, this is a good business decision in our view.

6. **On Your Marks** ... We are amazed, given uncertain market conditions, that managers continue to present their track records only on a projected basis (i.e., results are projected out several years through the completion of business plans, with assets being sold at a more optimal time). Moreover, investors seem to accept projected IRRs as an appropriate measure of performance. As managers are adhering to mark to market valuation requirements, we think the most relevant measure of the performance of unrealized transactions is capital invested compared to realized return on, and of, capital, plus today's marked to market valuations. While manager's marks should be viewed with skepticism, they are a more objective estimate than business plan projections. And managers can be held accountable to their valuations quarter to quarter, as deals are realized. Most successful managers have learned that in the long run, they will be better served by under-promising and over-delivering.

7. **In This Corner** ... The debate of REITs vs. Private Funds continues, and will not likely end any time soon. In our view, REITs and private funds are very different investment products and serve different roles in investment portfolios. Yes, REITs have outperformed private funds over the past 3 and 5 years. But is that surprising? REITs are primarily lower leverage, core strategies. In a 100-year flood, they should always outperform. Investing in a high yield private fund entails taking risk to generate outsized returns, including the risk of a loss of capital. So when the median performance of a high yield fund with a vintage of 2007 is 0.8x (i.e., a 20% loss based on current valuations), and top quartile performance is a 1.0x return, we would argue that the upside potential, relative to downside risk, has actually proven to be highly favorable.

8. **Look But Don't Touch?** ... While it may be scary to allocate capital to European investments in the face of widespread bad news, we would argue that now is the time to invest or at least allocate capital to experienced managers that will invest in Europe over the next several years. Many global investors may currently view Europe as akin to a museum ("look but don't touch"). But European real estate investing is beginning to attract a great deal of attention due to the significant amount of bank restructuring and the general dislocation in the markets. Judging from the large number of private equity houses that are actively building up their European presence (KKR, TPG, Cerberus, etc.), there is an expectation that there will be significant investment opportunities. In our judgment, Europe will provide an excellent environment to source investment opportunities from "stressed", if not "distressed" sellers, whether by playing the debt angle or through securing quality assets presently in the hands of unstable or undercapitalized owners. That said, institutional investors are not easily convinced of this, and are hesitant to enter the market too early. In the words of one prominent US institution: "with respect to Europe, I have assumed the crash position".

9. **Death by Jargon** ... We are often asked to define "core", "value add" or "opportunistic" investment strategies. This is particularly challenging when we see opportunity funds buy what appear to be core assets from REITs or core funds, only to lever up the assets and categorize the investment as opportunistic. Beauty, and projected investment returns it seems, are in the eye of the beholder. As such, we are encouraged that more institutions are categorizing their investments as a combination of long-term strategic holdings (the "strategic portfolio"), and a series of transitional holdings that offer a near term, higher yielding opportunity to re-position or otherwise enhance value (the "tactical portfolio"). In an industry that loves its jargon, we doubt that the core, value-add and opportunistic labels will be abandoned any time soon. But it seems appropriate (and refreshing) that institutional investors are revisiting definitions from the perspective of the role that the assets are intended to play in their portfolios.

10. **A Bear In The China Shop?** ... Finally, as the investment pendulum swings toward Asia, the question we are often asked is whether Chinese real estate is a falling knife to be avoided or the buying opportunity of a decade. In our view, at the moment, it is neither. Having assiduously managed the real estate sector for the past 20 years, the Chinese government is not about to let the market crash and put a very large dent in GDP growth at a time of domestic and global economic weakness. Let's not forget that the government itself implemented the rash of restrictive policies over the past two years to curb speculative development, consolidate the development sector and dampen sky rocketing residential values that have put home ownership well beyond the reach of most urban residents. We nevertheless expect to see weak real estate data for at least another two quarters, but eventually loosening measures will kick in and some stability will return to the market. The upshot of all of this is that after a very long time, we are finally seeing the risk-return equation for China property coming back into balance. With this, opportunistic returns are becoming achievable without venturing into third tier cities or taking on other types of excessive risk. Most managers who have been investing in China for some time are relieved to now be able to structure preferred equity deals on residential joint ventures with capable domestic developers (who previously did not need them) and they are seeing more rational pricing on retail and office property in first and second tier cities. Time is currently on the side of investors and it is undoubtedly a good time to be shopping.

And, since everyone always stops at 10, we thought we would provide one more market observation for good measure:

11. **Robbing Peter to Pay Paul** ... We have previously written about this concern, but it is worth repeating, especially since the increasing pace of loan maturities is forcing the hand of many managers. Investors should remain vigilant with respect to their investments in underperforming and under-capitalized funds, due to the risk of bad performance getting worse. While most managers are acting as good fiduciaries, we continue to observe managers that appear to be putting their interests before those of their clients. Decisions are being made to invest capital to sustain "negative equity" assets, enabling managers to sustain a stream of management fees. Sometimes the best decision a manager can make is to walk away from an investment, particularly when the equity will never see the light of day. Unfortunately, some managers are leveraging or otherwise using the equity from good fund investments to prop up bad fund investments. This is classic "good money after bad" and absent a high velocity recovery will likely lead to a compounding of losses.

Despite the "healthy skepticism" that shines through our observations, we firmly believe that there are always investment opportunities in certain markets and asset types resulting from unique situations or compelling strategies. Real estate is a highly inefficient asset class - very far from a commodity. A good manager can, in our view, add value on the buy, add value through hands-on asset management, create value on disposition, and as we've seen, create value through repurchasing debt. Moreover, buying at a deep discount to intrinsic value can be a very effective strategy, as Warren Buffett has proven time and time again. The challenge for an institutional investor remains how to select the right manager (or, just as importantly, replace a manager that is underperforming). In these uncertain markets, manager selection continues to be the key to generating alpha.

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