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& ASSOCIATES

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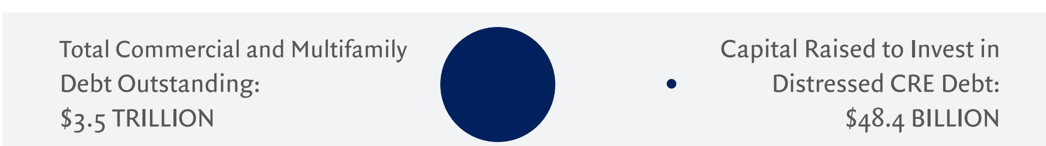
A New, New Paradigm

Nearly 20 years ago, The Yarmouth Group presented a year-end essay entitled "A New Paradigm." This paper outlined their expectations and ideas for the evolution of the real estate commingled fund structure resulting from the dislocation of the institutional real estate investment market. At that time, there was much commentary in the industry press that "we will never let this happen again." Yarmouth wrote that the industry needs to "…develop investment vehicles and fund structures that would survive, provide better transparency for investors, and an alignment of interest to help them avoid the worst excesses…" in an overheating market.

Fast forward to the current cycle, and we find that we have all somehow let this happen again. We are confronting new and complicated issues that appear insoluble, demonstrating similarities to the past, but with many more layers of complexity borne out of the financial market innovations of the past 20 years. Once again, there is a great deal of hand-wringing by talented and well-intentioned people in our industry as we confront a wide range of problem situations, while illiquidity reigns. Today's dominant fund structure, typically one variant or another of the "private equity/private fund partnership" is being blamed by some in the industry for contributing to, and exacerbating, the challenges arising within the global real estate market.

The past 18 months has given rise to a long list of idiosyncratic conditions impairing the proper functioning of the real estate private fund sector including: mis-alignments of interest, excessive-leverage, under-capitalized and bankrupt fund managers or parents, dispirited teams, management turnover, claw-backs being triggered, overwhelmed Advisory Boards, secondary LP interest overhang, LPs seeking to reduce fund commitments, LPs defaults, etc. It is a litany of woeful symptoms, arising from a capital market environment whose roots lie in the burst of monetary expansion following the tragic events of 9-11. The latent effect was too much credit, lax underwriting, a proliferation of questionable debt products, an inevitable era of hubris and a belief that the good times would roll forever.

Size of Distressed Asset Class vs. Capital Raised



Sources: Mortgage Bankers Association, Commercial Mortgage Alert, TriGate Capital; Data as of 6/30/09

It should come as no surprise that the investment vehicles of our era are struggling to withstand the devaluation of the commercial real estate market that was inflated by the extraordinary availability of leverage. Incentives and mis-alignments encouraged the excessive use of leverage and this became painfully apparent when the credit machine stopped. Today, only a "no-or-low" leverage strategy can withstand the withering pace of de-leveraging that prevails as private lenders have either disappeared or retreated to the sidelines.

LEARNING FROM THE PAST

While investors and fund managers are today reflecting on their poor or ill-timed investment decisions, there is an increasing emphasis on re-inventing the fund model. If we consider the last significant downturn that impacted the institutional real estate fund management community in the late 1980's, some themes and lessons start to crystallize. Most importantly, the fund managers and firms that opened their minds to a re-invention of their businesses are still here today.

The most significant "poster child" of the time, Prudential, was left for dead in the aftermath of the valuation debacle and gridlock impacting their open-end funds. Though they were not unique in this regard, Prudential became emblematic of the era due to an opaque valuation policy and a redemption feature that could not withstand the run on the bank. Today, 20 years later, Prudential thrives as one of the largest and most respected real estate fund managers. Despite exit queues in the open-end fund market rivaling those of the late 1980's, we have heard hardly a word about this organization in the current cycle. Other fund managers of that era, facing similar challenges but with less public notoriety, have disappeared, or have merged themselves into other companies along the way.

Why did Prudential survive and grow while other managers did not? Prudential's management, in those days long ago, realized that the key to their survival was a constructive engagement with their clients and investors. Open, frequent and relevant communications, improved governance, re-aligned economics, and the recognition that there are many stakeholders in the discussion, enabled Prudential to restore the stature that they continue to enjoy today.

What were the issues then — fees that were tied to subjective asset values without a proper alignment of interest, a lack of transparency, limited investor governance rights and illiquidity. And what are the issues now — fees that can sometimes appear to bear little reference to the actual invested capital and, in many instances, a loss of the alignment of interest due to value declines; limited transparency; governance that has many pitfalls when it is time to exercise control; and extreme illiquidity in the capital markets.

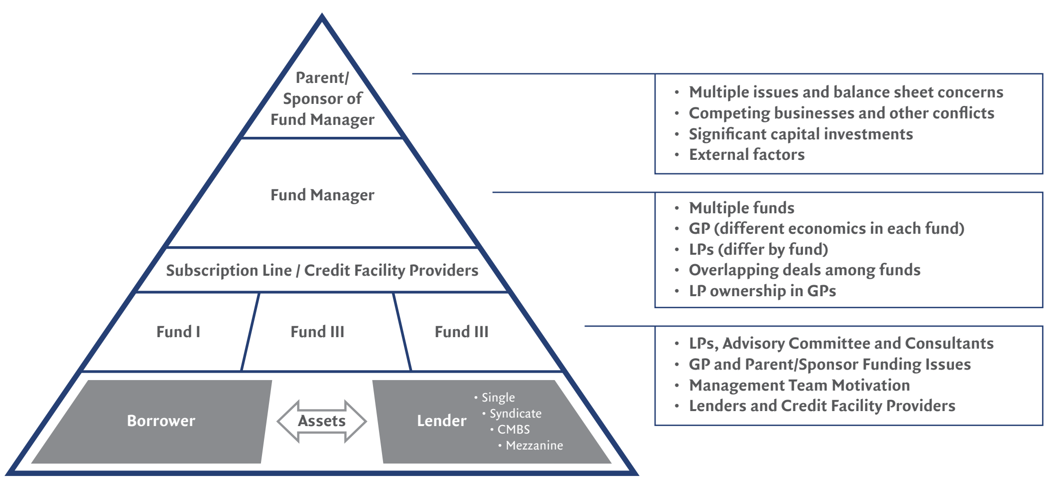
We can conclude that since open-end funds overcame these challenges to remain a meaningful part of the industry today, so too can the private fund partnership similarly evolve and survive, and continue to play an important role in the institutional real estate market. After all, some of the most talented real estate investors and the most unique transactions will be found in the private fund sector. Further, GPs have significant wealth tied up in their co-investments and carried interests and they will not lightly walk away from these businesses.

MIS-ALIGNMENT OF INTERESTS, 21ST CENTURY VINTAGE

One of the most significant concerns 20 years ago was the so-called "agency effect" — fund managers who were motivated to hold assets at unrealistic values because fees were tied to appraised values. Managers were motivated to buy (they earned acquisition fees), but not sell (they would lose asset management fees). Performance participations and carried interests were rare and managers earned fees to manage portfolios for the long term. Fund managers were rewarded for maintaining the status quo and even the most enlightened fund managers sought to hold assets as long as possible. Today, the focus is on an entirely different agency issue – namely, the solvency of fund managers.

GPs and LPs normally share an alignment of interest with respect to the management of their private real estate portfolios. This central tenet of the private fund structure is under serious threat these days. Each day, new situations arise that point out some new, latent mis-alignment that places pressure on managers and their funds. Alignment of interest, as dictated by the usual measures (e.g., co-investment capital and the carried interest structure), can motivate proper behavior, but only until circumstances reach the point at which there is a question of basic survival. Otherwise, they can become contra-incentives, the law of unintended consequences kicks in, and we find some entirely new set of complications.

HIERARCHY OF STAKEHOLDERS



While everyone believes that the substantial majority of GPs judiciously consider individual investment decisions, LPs are beginning to fear that their GPs (typically 1-to-10 % of the equity capital) may be tempted to base decisions on fee-generation, fee-perpetuation or worst of all, survival. Some LPs are concerned that capital calls designed to de-lever portfolios equate to "throwing good money after bad" but feel ill-equipped to analyze the proposals since their GPs control the information. LPs have expressed concern that their managers may be incentivized to pursue portfolio re-capitalizations in order to perpetuate a fee stream from a portfolio that might be insolvent. Other LPs have expressed concern that some GPs are not looking for investments because they are unable to fund their co-investment capital. Still others fear that real estate fund managers within larger organizations will become impaired due to difficulties in other unrelated areas of their firm. These are the "agency issues" of the current market cycle that are arising amidst a steady deterioration of trust and a breakdown in communication.

FROM DEFENSE TO OFFENSE

Finally, there has been much discussion of the re-calibration of work ethic that is one hallmark of this current economic downturn. Excessive leverage, and a massive expansion of the money supply, gave rise to a generation of managers who believed that 1) fund management and the generation of performance was simple, and 2) fund management was a way to make money quickly while their organizations also developed entity value from growing assets under management.

This era of entitlement gave rise to a significant compression in the formulation of business plans. What had historically been a four- to five-year fund cycle (i.e., raise a fund, invest the fund) turned into a one- to two-year cycle at the peak of the market. Too many fund managers developed business plans, and cost structures, that would be severely stressed if they missed a beat at this accelerated pace. Many fund managers find that the current environment cannot support a viable business platform, let alone generate the levels of wealth they had grown to expect. Today, the fund cycle has reverted to the more traditional four- or five-year period. Fund managers are grappling to adjust business plans and expectations to reflect the new reality. Given these conditions, some re-invention of the fund model is both healthy and inevitable for all the stakeholders.

We agree that the GP survivors will need to open their minds to LP concerns about fee levels, control, transparency and effective governance. However, this is not a one-way street. LPs cannot view this solely as an exercise in reducing fees and neutering management. Reducing fee levels may only serve to hasten the reduction in staffing levels and, presumably, the ability to recover value. Reducing fee levels while creating new incentives could offer a meaningful solution and keep everyone focused on the greater outcome — recovering more capital than you would generate even by reducing fee levels to zero.

Fund managers need to examine the strengths and weaknesses of their own platforms and communicate a thoughtful business plan while keeping in mind the investors' objectives. This is the only way that they will earn the support of their LPs to secure growth capital for either portfolio re-capitalizations or new opportunities.

It is very encouraging that the tone of communication between GPs and LPs has generally remained positive throughout this recent period. In fact, in an odd turn of events, investors are bemoaning that they do not have enough time in the day to be responsive to the enhanced outreach and communication programs initiated by their GPs. This is a far better situation than 20 years ago when fund managers were dragged to the table (or more vividly, before state legislatures where their testimony was mandated) to explain what was going on.

However, having active communication is not enough. We need a transformation of the content of GP/LP communications away from "who's to blame" and focused toward "what happens now." This will require fine-tuning communications to better facilitate the dialogue. The goal we should all seek is a realistic assessment among all of the stakeholders of the prognosis for their assets, portfolios, funds and organizations, and it will require transparency and realism on all sides.

Some GPs reject the notion today that the world has changed, and remain firmly in denial about their issues. There are some LPs that quietly voice their indifference – and are prepared to let the fund managers' wallow in their misery. We are firmly committed to the view that everyone in the market has much to gain by participating in "constructive engagement" rather than a prolonged cycle of mutual recrimination.

LIGHT AT THE END OF THE TUNNEL?

The outcome we work toward is that most (but not all) fund managers will be able to survive, and LPs will eventually recover more of their capital than might seem obvious today. We like to believe that many, and hopefully most, troubled fund investments will eventually be resolved to everyone's reasonable satisfaction. That said, we are realistic about the recovery of capital from investments made at the top of the cycle. We further recognize that certain vintage results will appear acceptable only on a relative basis, falling far short of the target IRRs and multiples that had previously been promised.

The current difficult environment does not portend the demise of the private fund structure, however. What is obvious is that we have all learned many new lessons - painfully - about how mis-alignments can arise, so the funds of the future will inevitably reflect the greater experience we have gained during this period of extreme market stress. As before, the survivors and new businesses that arise from this current environment will learn from these lessons. They will redirect their business models and portfolio strategies to enhance best practices with respect to the advice they render, the investment vehicles they develop and the relationships they build with their partners and clients

So, to state the obvious, we all have much to gain from a strong commitment to constructive engagement. In order to re-establish trust, it will take hard work and a significant commitment to effective communication, as well as an honest re-appraisal of the alignment of interest that underpins the private fund structure. The sooner LPs gain confidence about what the future might resemble, and the sooner that GPs understand that the business is evolving, the sooner the real estate private fund industry can move from defense to offense. And that is an outcome that will benefit all.

HODES WEILL & ASSOCIATES

Hodes Weill & Associates ("HW&A") provides independent advisory and restructuring services to limited partners, fund managers, advisory committees, lenders and other interested stakeholders within the real estate private equity and private funds industry. In this capacity, HW&A seeks to bridge communications, conduct reviews, analyze conditions and establish decision-making frameworks that may become necessary when fund managers and investors need to revisit the basis upon which they have organized their funds, specific investments or entire fund platforms. In addition, HW&A is focused on sourcing and investing capital to assist in the recapitalization and restructuring of fund managers, funds and/or fund portfolio investments.

HW&A was formed to build upon the 30- and 20-year careers of its founding partners, David Hodes and Doug Weill, in the institutional real estate market. From 2000 to 2009, along with a third partner, Hodes and Weill led the Real Estate Private Fund Group ("REPFG") at Credit Suisse. REPFG is the dominant advisor and placement agent in the real estate funds Industry, and has been consistently recognized for delivering high quality fund investments to the institutional community.

HW&A maintains relationships with a broad range of fund managers, institutional investors and consultants on a global basis. HW&A seeks to leverage this global network of relationships to help provide advice and thoughtful solutions to a wide range of situations that are impacting a rapidly changing industry.

HW&A is 100% owned by the principals. Further information can also be accessed on the Company's website at **www.hodesweill.com**.