

OBSERVATIONS OF THE REAL ESTATE MARKETPLACE

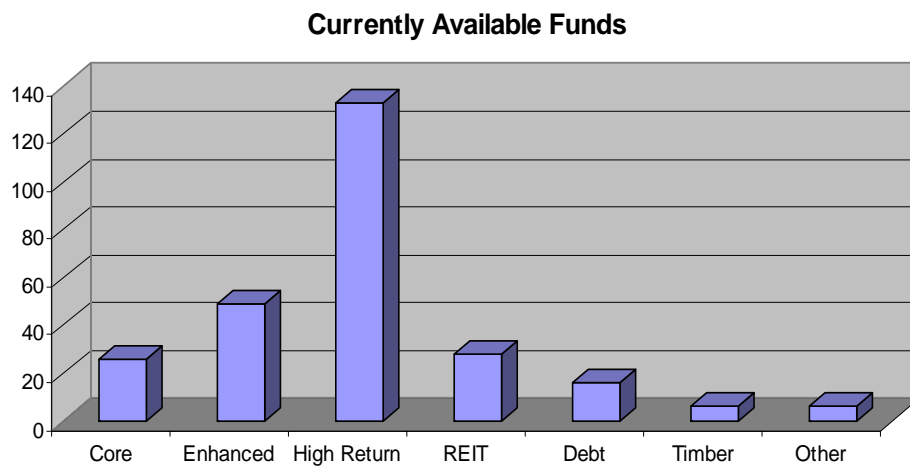
Everyday we open our newspapers or turn on our television and one message is consistent and clear – the world is changing and it is changing at an unprecedented pace. Whether it be geopolitics, technology or finance we are witnessing a period of unparalleled change. And the asset class of real estate is evolving in this dynamic environment in which we live. And with that change come great opportunities and unexpected challenges.

I have been asked to share some of my thoughts and observations regarding U.S. real estate investment managers. Let me qualify my comments by saying that a proper discussion of the investment manager class could easily encompass a book. I can only provide limited comments and must use generalizations. Please forgive any errors this may cause.

I began providing real estate consulting services to institutions nearly two decades ago. It was a simpler time and place. Nearly all institutional investors had the same investment strategy. It was to invest core assets. That meant a fee simple interest in operating and substantially leased office, retail, apartment and industrial properties located in major metropolitan areas in the United States. For all intents and purposes there was no public market, no international market, and a limited non-core market.

At the time the question we asked ourselves was it the chicken or the egg. Did institutional real estate investment programs' strategies look alike because there was little differentiation in investment product, or was there little differentiation in investment product because all the institutional investors wanted the same strategy? It is a question for which I doubt we will ever know the answer although I suspect that the answer is a little bit of both. But there is one thing we do know for certain and that is that the asset class has changed and changed dramatically during the past decade. And that change has had profound implications for all the participants including the investment managers.

Today the asset class is not just private market but also public market investments. It is not just domestic but global. It is not just equity but debt. It is not just core but it is also non-core. And non-core offerings have a diverse range of strategies, risks and returns. In fact rather than comprising the minority of strategies non-core pooled funds now dominate the investment offering landscape. Below is the number of pooled funds currently available for investment by investment style.



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These changes have empowered the institutional investor. In the simpler world where most institutions had the same strategy the difference in return was driven primarily by the investments made by the managers. But that is not the case any longer. The decision which an institution makes regarding its investment strategy will be the most important determinants of the institution's intermediate and long term returns. Whether the institution invests in U.S. core open end commingled funds or in international high return opportunity funds or in public REITs is more important to the returns of a well-diversified program than the properties or investments which the managers make.

But with every right comes responsibility and this case is no exception. Today the institutional investor must know exponentially more than ever before. On any given day it may have to decide whether to invest in NPL's in Germany, to develop office in India, to favor retail over office in the US, to invest in a global REIT program, to use structured finance offerings to mitigate the risk of rising cap rates, to ... well...simply the list goes on and on. Why? Because today the investment managers are sponsoring pooled funds that have a wide array of strategies.

Underwriting an investment manager means first underwriting complex and sophisticated strategies. The asset class is dynamic. Its investment strategies are spanning the globe and are accessing less transparent markets. As the investment universe expands the task becomes even more daunting.

When we began our firm we had a much smaller staff, but the tremendous growth of the asset class mandated that we develop a deep infrastructure with areas of specialization in order to have a true expertise in every segment in which we underwrite managers' investment product. It still presents a challenge even with our platform. The investor risks that it will become a jack of all trades and a master of none as it tries to keep abreast with emerging investment opportunities.

An investor must truly understand the fundamentals of the investment strategy if it is to underwrite the investment manager. That is not an easy task because not only have the number of investment strategies increased exponentially but also because managers are increasingly investing in less transparent markets. An investor must thoroughly evaluate and understand the managers' skills especially when the managers enter new market segments and when those segments are less transparent.

We have observed many managers offering the "hot" strategy of the day. With so many new ideas to follow there is a great risk that the investor has neither the time nor the expertise to thoroughly underwrite these new ideas or the time to really know the managers' platforms in the new investment areas. Investors frequently get caught up in the momentum of the market and commit capital. Emerging strategies can provide tremendous returns but also significant loss if not executed by well. It is important to be aware that there are a higher percentage of failures when managers try to establish the infrastructure to execute new strategies in new areas. This is often hidden by survivorship bias. This risk should not be underappreciated by the investor. If you don't thoroughly understand the area and the manager's platform then don't invest.

This is a more challenging task because managers are requesting broader investment mandates and the structure of the investment manager model is changing. When I began providing consulting services not only was it a much simpler investment universe but it was also much simpler to define what a manager did for a living. It bought, managed, and sold properties. That all has changed. The correction in the real estate market that occurred during the early 1990s provided the opportunity for existing managers and new entrants to reconsider the manager's role and its structure.

Perhaps the most well-known evolution in the manager model is the opportunity fund managers. These “allocators” identify timely strategies, allocate capital and structure the investment. More often than not another firm – usually a real estate operator – makes, manages and sells the investment. This model brought liquidity to an illiquid market in the early 1990s but we no longer have an illiquid market. In fact many would and do cogently argue that we have too much liquidity in the market. And yet the allocators continue to thrive. Why?

The allocator model allows a broad investment mandate to an emerging and diverse set of investment strategies and structures. It allows the manager to capitalize on speed of execution and sophisticated capital structuring skills. It allows for a separation of fiduciary investment oversight and fundamental real estate skills. It allows the manager to have diverse and specialized real estate skills without having to internally develop the infrastructure. It greatly expands choice of investment opportunities.

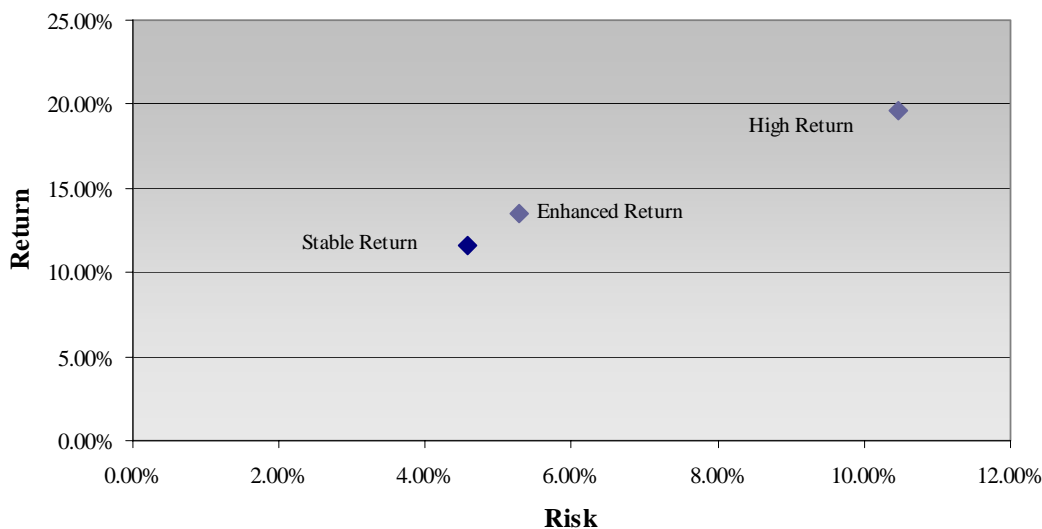
It can easily be argued that the allocator model introduced the investor to international investments, complex and sophisticated investment strategies and structures, and specialized operating partners. It introduced many real estate operators to institutional capital. Those same firms including many public REITs are now offering investment product directly to institutional investors. These operators often bring a very high level of expertise to specific segments of the market.

An investor must understand what manager model is being offered because each has its own set of risks and rewards. An investor must understand what type of skill set it is looking for. Is it a traditional manager; a real estate operator, or an allocator? The best model will depend upon the strategy, the investor and the cost. By the way sometimes the answer can be “all of the above” or “none of the above”.

It should also be noted that there have been many changes in ownership of the management firms and a significant turnover in the senior personnel of even the most successful firms. An investor must understand who it is underwriting. At the end of the day it is the people. And don’t think fee structures are the simple solution to personnel stability and alignment of interest. It requires thoughtful and diligent underwriting to select the team that will be there for you today and tomorrow. You must know the team and understand the culture of the firm.

Investors have all read the past performance is not a guarantee of future performance – but our studies have shown that there is a strong correlation. The challenge with real estate is to be able to understand and measure past performance. The first issue is to find an appropriate benchmark. There are limited indices available by which to measure private market real estate performance. The NCREIF Property Index is the most frequently used benchmark for U.S. private market performance, but it measures only unleveraged core returns. NCREIF has developed fund index but this also addresses only a minority of the strategies. We have developed proprietary indices for private market institutional real estate and below are the historical time-weighted returns for three of our classifications. As you can see the risks and returns differ widely by sector.

Style Sectors Risk Return Characteristics Ten Year As of 6.30.05



There are more challenges than simply finding an appropriate risk and return benchmark by which to evaluate a manager's past performance. There is the method by which performance is calculated. For example, many managers will state that the performance is based upon a valuation policy that marks investments to market. For the open end core funds, this will mean that at least once a year the manager will have independent appraisals prepared and during intervening quarters the values will be prepared by the managers. These are the most transparent funds. The policies regarding "mark to market" will vary widely as the investor considers managers that offer strategies with more risk and more complex investments. To "mark to market" for one manager will mean an annual discounted cash flow analysis of every investment but for another manager will mean no change in the value of an investment unless there is a significant event such as a partial sale of the securities that comprise the investment or the loss of a large tenant.

Another issue to consider is whether the performance is based upon realized or unrealized returns. Our studies of the opportunity funds indicate that projected unrealized returns are generally higher than the returns which are eventually realized and that the longer the holding period of the investment the more likely the realized return will be less than the projected unrealized return.

It is also important for an investor to understand the factors that drive past performance. It will enable the investor to better predict the manager's ability to succeed in the current market environment. We will review the performance of each asset rather than simply the fund level performance. This allows us to better determine where the manager has created value and to determine if those skills are consistent with the current investment environment. It also enables us to determine if performance is being driven by a few large investments or if the performance represents that the manager has consistently made superior investment decisions.

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Perhaps one of the most overlooked and opaque sectors of manager underwriting is the fees and other costs of an investment. We will frequently hear a manager reference its superior returns but more often that not these are before fee returns and calculated at the investment level rather than the fund level. Consider the following. A very successful manager recently stated it had made an investment that will return 21%. This sounds terrific but by the time the fees and costs are paid the expected net return to the investor is approximately 13%. The fees and costs are 8%. We know real estate is an inefficient asset class but this example begs the question - is it so inefficient that the investor is properly being rewarded for the additional risk when it pays 40% of the total return in fees and costs? To make matters worse, for this specific investment the expected return was 21% using leverage but the expected return calculated without leverage was only 11%. The use of leverage comprised nearly one-half the total expected gross return.

Here are some questions to ask when underwriting a manager's fees and costs. How frequently is an operating partner used and what is the average sharing of return with those operating partner? For example, certain opportunity fund managers always use operating partners and others rarely if ever do. Is there an "asset management fee" in addition to the investment management fee? Frequently investment manager or an affiliate will charge an asset management fee on all or part of the invested capital in addition to charging an investment management fee. While the asset management fee is represented simply to cover costs it can be substantial. For some managers it can be as much the investment management fee.

It is also important to understand which costs are being born by the fund. They can range from dead deal costs to pursuit costs. The costs are in addition to the fees and they can be significant. For example, one successful manager's pursuit costs which are passed to the fund average more than 1% of committed capital during the investment period and include the pro rata compensation of the manager's most senior personnel.

Finally an investor must understand the effect of the diverse fee structure because the investor is interested in the returns it receives after fees. Below is an analysis we modeled comparing the average "value" manager fee with the average "opportunity" manager fee.

Gross Return	10.0%	15.0%	18.0%
Opportunity Fund net return	7.7%	11.4%	13.5%
Value Fund net return	8.8%	13.2%	15.8%

This chart illustrates that an opportunity manager has to provide a gross return that exceeds the value manager's gross return by approximately 20% in order to provide the same net return of 13%. As expected returns decline (which most industry participants predict) this issue becomes more important. In this case the primary reason for the difference in fees is the catch-up fee, but it can be many elements of the fee structure and each must be understood.

This is a great time to be an institutional investor. The investment choices have never been as many and the ability to craft investment programs has never been as great. But the task of underwriting managers and funds has never been as demanding. You must know and understand the strategy and this can be challenging in a global marketplace with an increasing number of investment strategies in new areas. You must know your manager. The management industry has undergone significant ownership change and senior personnel turnover. You can't rely on fee structures to guarantee stability. You must know the

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people and understand the culture. You must understand the manager's model. As managers venture into new investment areas the risk of failure increases. You must understand the risk and return in an asset class void of appropriate benchmarks. And it is not sufficient to accept the represented return. You must verify it and evaluate it to determine the value the manager has brought to the investment process and to determine if those skills are consistent with today's investment environment. You must consider net returns because this is the return you will receive. It requires you to understand complex and frequently opaque structures. But it is necessary to make an informed decision regarding appropriate risk-adjusted returns.

In the end underwriting a manager is a commitment to knowledge. As America's first President George Washington said, "Perseverance and spirit have done wonders in all ages". Be diligent.