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Market Outlook

Trends in the Real Estate
Private Equity Industry

Ernst & Young is pleased to present our 2007 *Real Estate Private Equity Market Outlook*. With several years of extraordinary growth and prosperity on record, 2007 is shaping up to be an inflection point for the changing opportunities and challenges of real estate private equity funds.

Highlights from 2006 include a continuation of the flood of capital to the sector, significant investment trading in all forms, and outsized returns being reported by most fund sponsors in the space.

The first half of 2007 reflected much of the same. Capital was abundant, and real estate fund sponsors looking to raise capital found fairly fertile ground. Fund sponsors attempting to monetize their investments reaped the rewards of abundant liquidity which contributed to very low cap rates by historical standards. However, fund sponsors with capital to invest at 20% returns were challenged by the enormity of investment competition in mature markets such as the US and Western Europe and the complexity of execution in emerging markets such as China, India, and parts of South America.

The Credit Crisis—New Challenges

At the start of the second half of the year, the US witnessed a capital markets dislocation that is likely to be written into the history books as the “credit crisis of 2007.” Touched off by escalating default rates on subprime mortgages in the face of a softening US housing market, the credit crunch quickly spread to the commercial mortgage area and broader commercial credit markets. Demand for subordinate debt securities dissipated rapidly and led to a significant widening of spreads on debt of any kind. By the first days of August, most lenders had pulled back the reins on new underwriting, with genuine concerns about the ability to securitize debt, and related effects on pricing were felt around the world.

These shifting market conditions have created a new set of challenges and opportunities in the real estate private equity world. As low-cost, readily available debt capital arguably fueled the significant real estate market appreciation over the past several years, this pullback of debt capital is expected to lead to a period of slower transaction velocity and general cap rate expansion. Additionally, until stability returns to the debt markets, more complex transactions may not be underwritten at all by traditional lending sources. The investor flight to safety, causing illiquidity at the high-risk end of the investment spectrum, is also viewed as a great opportunity for new investment at greater yields than were available in the recent past. We have heard widespread reports of real estate private equity funds accumulating capital to take advantage of the pricing opportunities resulting from this liquidity crisis.

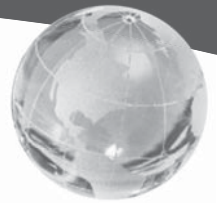
Our *2007 Market Outlook* delves into the real estate investment cycle and provides insight on the state of the industry through the first half of the year and its outlook for the future.

Tax, Accounting, and Other Developments

Our *Market Outlook* report also summarizes some interesting tax, accounting, and market developments that are likely to be top of mind for the real estate fund community.

High on the list is a recent legislative proposal that would recharacterize to ordinary income certain capital gain allocations related to a sponsor’s carried interest. This proposal has evoked an immediate and passionate response from the industry and is likely to be among the most closely monitored and hotly debated legislative proposals in years.

Perhaps overshadowed by the proposed tax legislation, but nonetheless important, the accounting standards setters have issued new



pronouncements on investment company accounting and fair value reporting. Although changes in accounting principles can be challenging, these new standards may represent the first steps toward eliminating the diversity of reporting that exists within the industry and may help create more transparency and comparability across the fund spectrum.

We also touch upon the completed and announced initial public listings of alternative asset managers in 2007. Their success or failure may have an influence on the more traditional mainline real estate fund sponsors. The tax advantages of the publicly traded partnership structure generally used in these initial public offerings are under attack by legislators, and this may discourage asset managers, including those in the real estate space, from following suit. Only time will tell on this development, but it is clearly one to watch.

Thanks to Our Survey Participants

We would like to thank the sponsors that participated in our survey and contributed to this research paper. With so many fundamental aspects of the real estate fund landscape moving at the same time, we cannot help but feel that the remainder of 2007 and 2008 have the potential for significant change. We wish all the players in this exciting environment continued success.

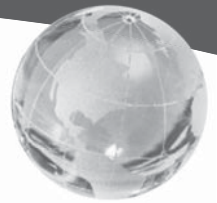


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7 September 2007

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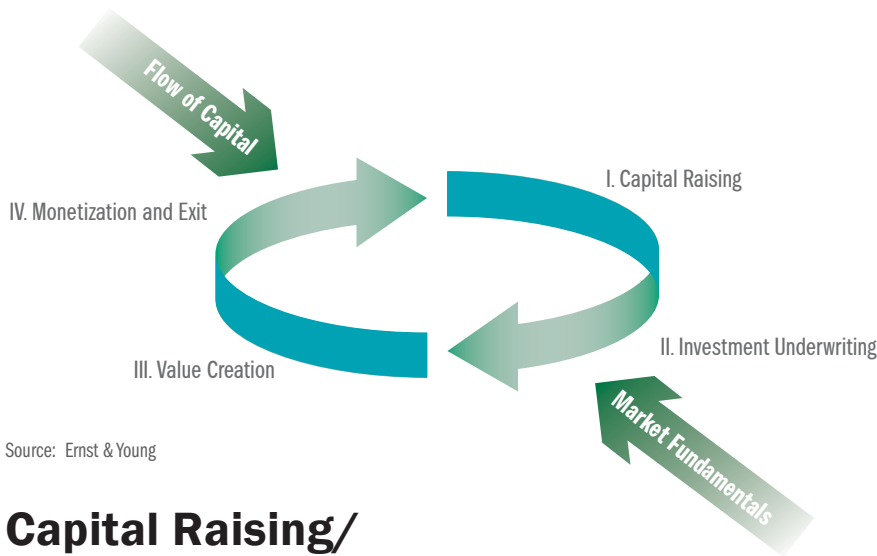


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Real Estate Fund Cycle Observations and Findings

Real Estate Fund Cycle



Source: Ernst & Young

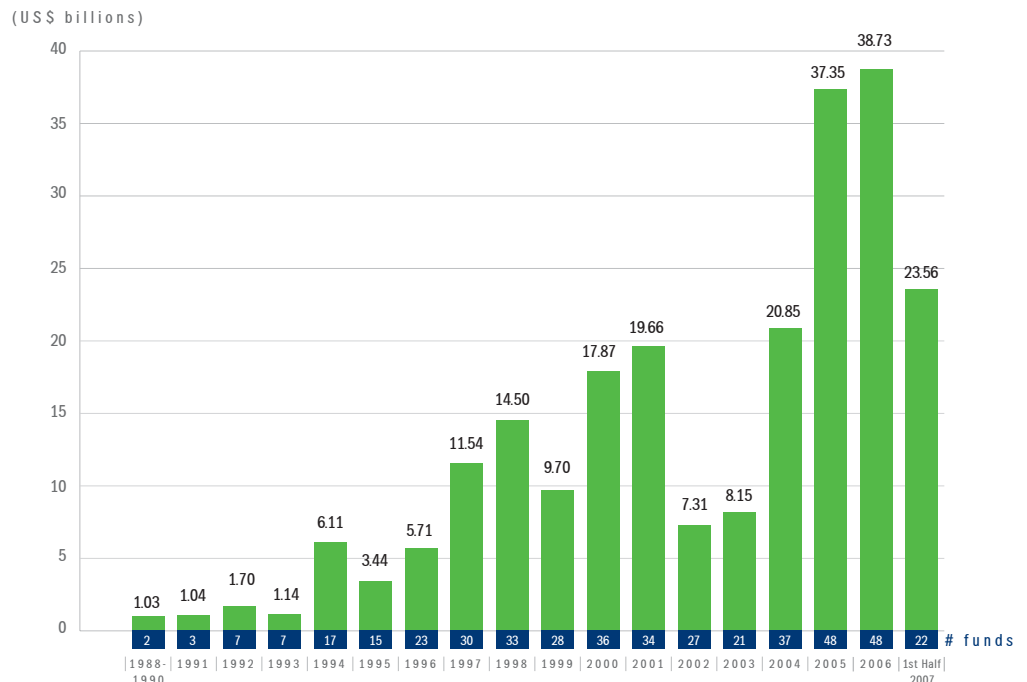
Capital Raising/ Availability

The real estate private equity fund market has dominated the real estate landscape and is arguably the most significant driver of real estate transactions today. Through the first half of 2007, capital flows to real estate were still very strong. Our survey respondents have raised more than US\$225 billion of capital since 1991 with more than US\$38 billion raised in 2006 and US\$23 billion raised in the first half of 2007. An additional 35 funds with targeted capital of US\$35 billion are in the process of being raised. As discussed later, in the monetization section of this report, returns being reported were generally in line with or ahead of expectations. Considering the returns on alternative investments over the past year, real estate private equity performed comparatively well on a risk-adjusted basis. In light of the strong fund performance, 84% of our survey respondents believe that capital flows to real estate will increase or at least remain at the same high level for the balance of 2007 and for 2008.

While some pension funds may be bumping up against their real estate asset allocation percentages, others are still racing to catch up as a result of being underweighted in this asset class during a period of tremendous market appreciation.

As shown in the Investor Base Composition chart on the next page, for larger funds of more than US\$500 million, more than half of the capital being raised comes from pension funds, foundations, and endowments. In smaller funds of US\$500 million or less, a smaller portion of capital raised comes from these sources while more than a quarter of the capital comes from high net worth individuals. The fund sponsor and its affili-

Total Fund Equity Raised (by year)

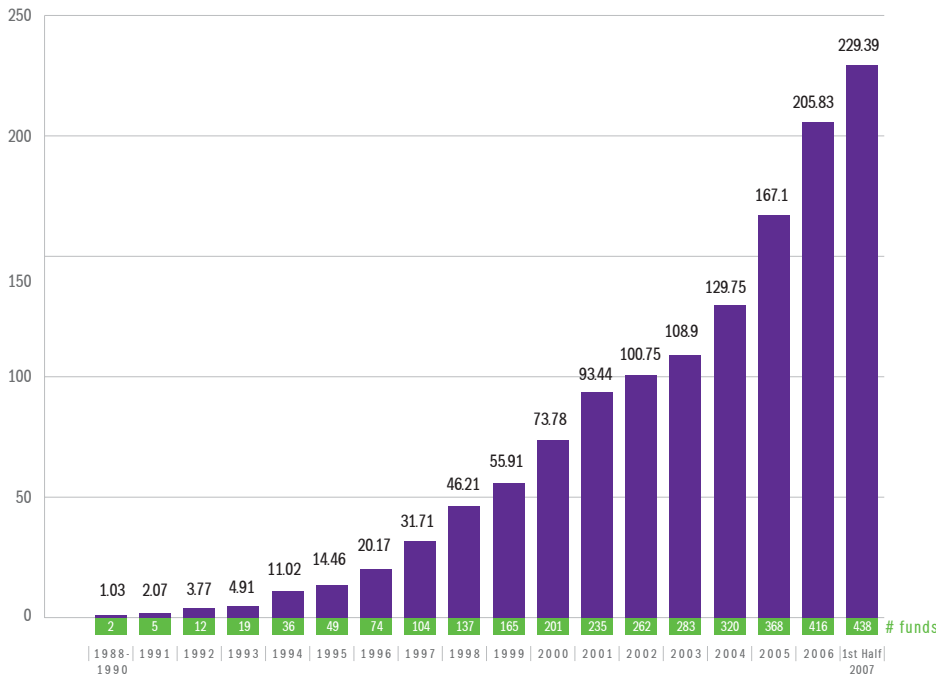


Source: Ernst & Young



Cumulative Fund Equity Raised (by year)

(US\$ billions)



Source: Ernst & Young

ates make up an average of 5% of fund capital on a combined basis. Although more common in the traditional hedge fund or private equity fund space, we are also starting to see greater capital sourcing from real estate fund of funds.

The following observations support the view that the capital-raising portion of the real estate fund life cycle has been robust:

- Fund sizes are still growing
- New funds continue to proliferate
- There is a high level of recommitment of capital to successful fund sponsors in their successive funds.

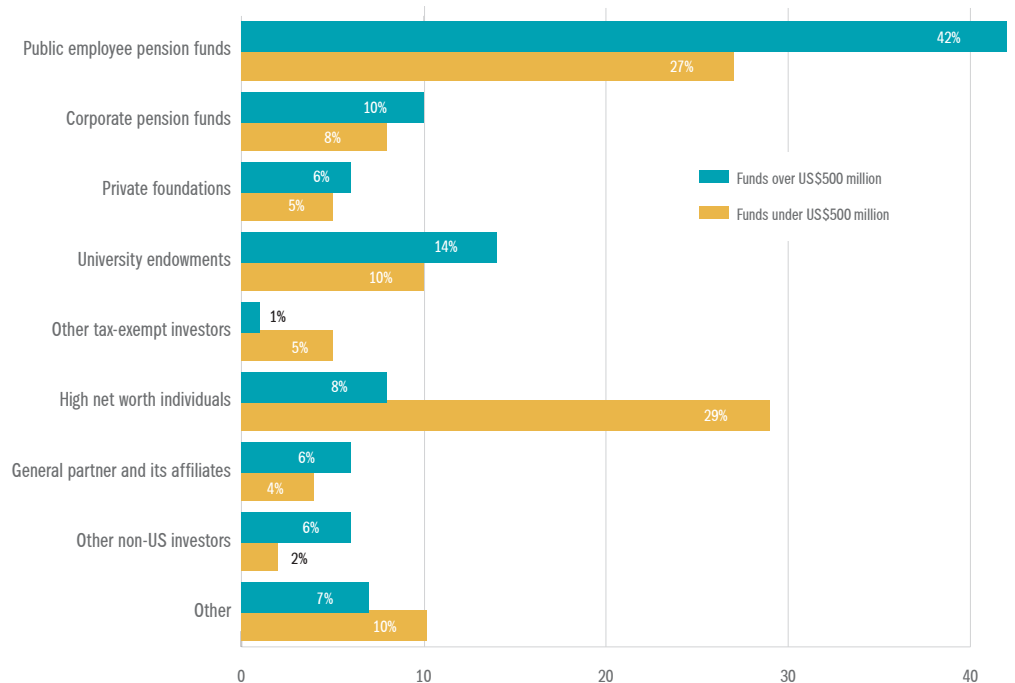
Fund Sizes Are Still Growing

Without a doubt, the average fund size in the industry continues to grow. Based upon our survey, the average size of the funds raised from 2005 to 2007 was US\$844 million. This is up 79.5% from the average size of funds raised from 2001 to 2004. Where multibillion dollar funds were once few and far between, they are now more common, with even those first-time fund sponsors we

interviewed looking to close their funds at US\$1 billion or more. This is a clear indication of the magnitude of capital seeking real estate private equity returns.

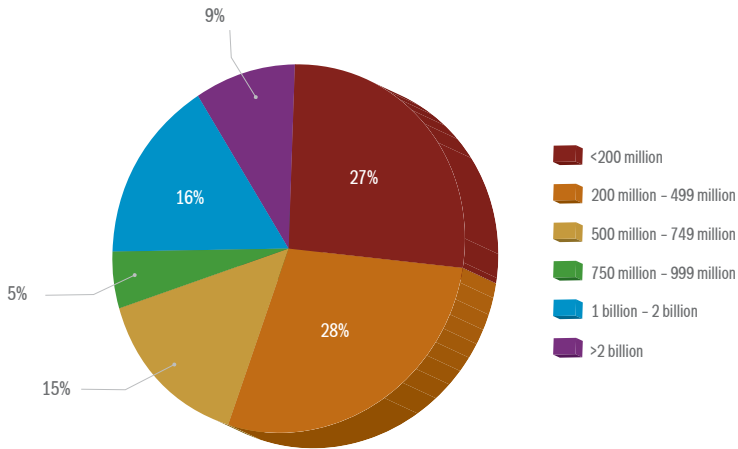
Interestingly, conventional wisdom would suggest that fund sizes are linked to the amount of capital a fund sponsor can reasonably invest at or above the fund's return expectations during the investment period (usually about three or four years). Following this logic, the growth in fund sizes would seem to reflect what must therefore be the fund sponsors' increasing confidence in their ability to identify and capture real estate market opportunities. Indeed, many recent examples can be cited of fund sponsors fully committing to investment opportunities and reaching the limit of their subscribed capital in a fraction of the time permitted in their investment windows, prompting the launch of even larger funds. However, this experience is not universal.

Investor Base Composition



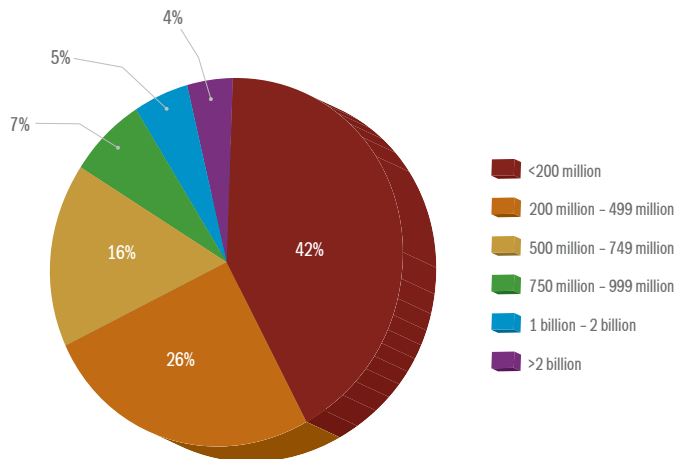
Source: Ernst & Young

Fund Sizes, 2005 – 2007, US\$



Source: Ernst & Young

Fund Sizes, 2001 – 2004, US\$



Source: Ernst & Young

As discussed in the capital deployment section of this report, the significant capital availability that has supported the fund-raising portion of the cycle has fueled tremendous competition for investment opportunities. Based on some of our interviews, caution appears to have crept into the psyches of some fund sponsors, and these fund sponsors have bucked this increasing fund-size trend. These fund sponsors believe that the increased competition for investment opportunities has and will continue to put pressure on the fund-size decisions of tomorrow.

New Funds Continuing to Proliferate

In our 2005 market research paper, we noted a marked increase in the number of new funds coming to the market. In 2006 and the first half of 2007, this trend has continued and perhaps even accelerated: 36% of the funds raised in the last 18 months by our survey participants were raised by first-time sponsors. These new fund sponsors came from numerous sectors within the real estate investment community. However, one of the more significant trends relates to investment professionals within large funds who have left to start funds of their own. Investment professionals we spoke to indicated that they had helped their former employers successfully invest billions of dollars over the last three to five years and were looking to continue their success under their own banners.

Another interesting trend is the attempted disintermediation of the mega-fund by local real estate developers. In years past, large fund sponsors, often referred to as “capital allocators,” would joint venture with local developers to combine their capital effectively with local development expertise, often to great result. These developers, recognizing the returns made by these large funds, are attempting to eliminate what they see as the middleman and go directly to the pension plans to raise capital for funds of their own. They argue that the value being created by the fund intermediary is insufficient to justify the double promote, i.e., a carried interest allocation to both the developer and fund sponsor. As a counter to these claims, mega-fund observers point out that these local developers often don’t



Composite Fund Characteristics

The following is a composite of fund characteristics compiled from the survey responses received:

We asked fund sponsors what terms within the fund documents potential investors are looking to change or renegotiate. The top three terms indicated were:

- The fund sponsor's catch-up percentage
- The preferred return hurdle
- The management fee percentage.

Both the average preferred return hurdle and the average general partner catch-up percentage were lower in the current study than the averages noted in our 2005 research paper.

Average fund size (2005-2007)	US\$844 million
Percentage raised from sponsor/general partner	6.7%
Targeted gross returns	19.7%
Targeted net returns	16.3%
Preferred return hurdle	9%
General partner promote	21%
General partner catch-up percentage	35%

Source: Ernst & Young

have the scope and depth of organization to support a multi-investor/multi-project fund. These larger fund sponsors argue that where the local developers created value by intensively managing two or three development projects each year, their attempt to broaden their focus and increase their volume will dilute the intensive management focus on the development process that made them successful in the first place.

The proliferation of fund players and the continued success of established funds with deep track records are starting to put pressure on the ability of new fund entrants to reach their capital raising targets easily. One new fund sponsor observed that the first question they have to answer is why rational capital should invest in their fund over the many fund options available with deep established teams and a clear and consistent track record.

There Is a High Level of Capital Recommitment

In the face of performance returns that seem almost universally positive, one trend of note is the recommitment of capital by investors to a fund sponsor's successive funds. Many market participants have noted that when it comes to making

investment decisions, there is no substitute for performance consistency. Consistent performance returns at or above return expectations were characterized by one interviewee as "nearly addictive." Of course, fund-offering documents all tend to say "prior investment performance is not necessarily predictive of future investment results," but this disclosure has not appeared to impact the trend. Recombitment by investors to next-generation funds is widely reported as being very high. If outsized performance returns continue unabated, it doesn't seem likely that this trend will change.

Investment—Capital Deployment

General Observations

After its final closing, a real estate private equity fund moves into the investment portion of the fund's life cycle where, some have said, the real work begins. The return expectations of our survey respondents averaged 20% gross and approximately 16% net after considering fees and the fund sponsor's carried interest. The fund sponsor generally has three or four years before the invest-

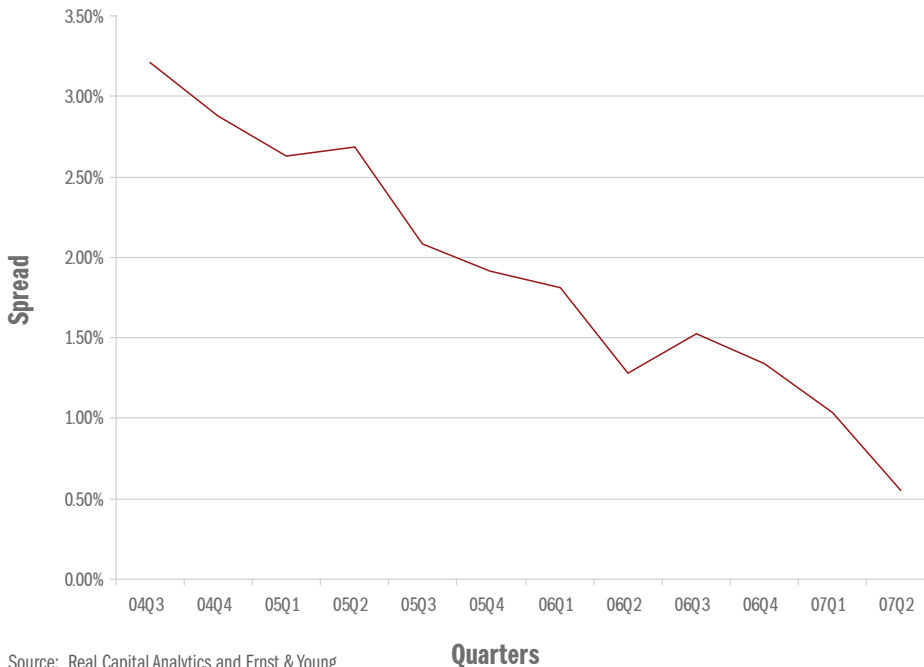
ment period expires to leverage the committed capital into deals that will meet these return expectations. Capturing these investments would be difficult under any circumstances, but considering the hundreds of other funds with teams facing the same challenge, the degree of difficulty expands almost exponentially.

We posed the survey question "What is it that keeps you up at night?" Almost 70% of our respondents answered in the same way: finding investment product that will meet their return expectations.

The extraordinary level of capital that has flowed into real estate through the first half of 2007 continued to compress cap rates to historically low levels. The market pessimists of last year were certain that the trend would reverse itself in early 2007. One investment sponsor was heard to say at an industry conference that at a 5% cap rate, all properties are broken. Yet large transactions were still being closed at 4% cap rates in the second quarter of 2007.

This prompts the question: How long can this trend continue?

Spread Between 10-Year US Treasuries and Average US CBD Office Cap Rates, Q3 2004 to Q2 2007



Source: Real Capital Analytics and Ernst & Young

Real Estate Fundamentals and Market Momentum

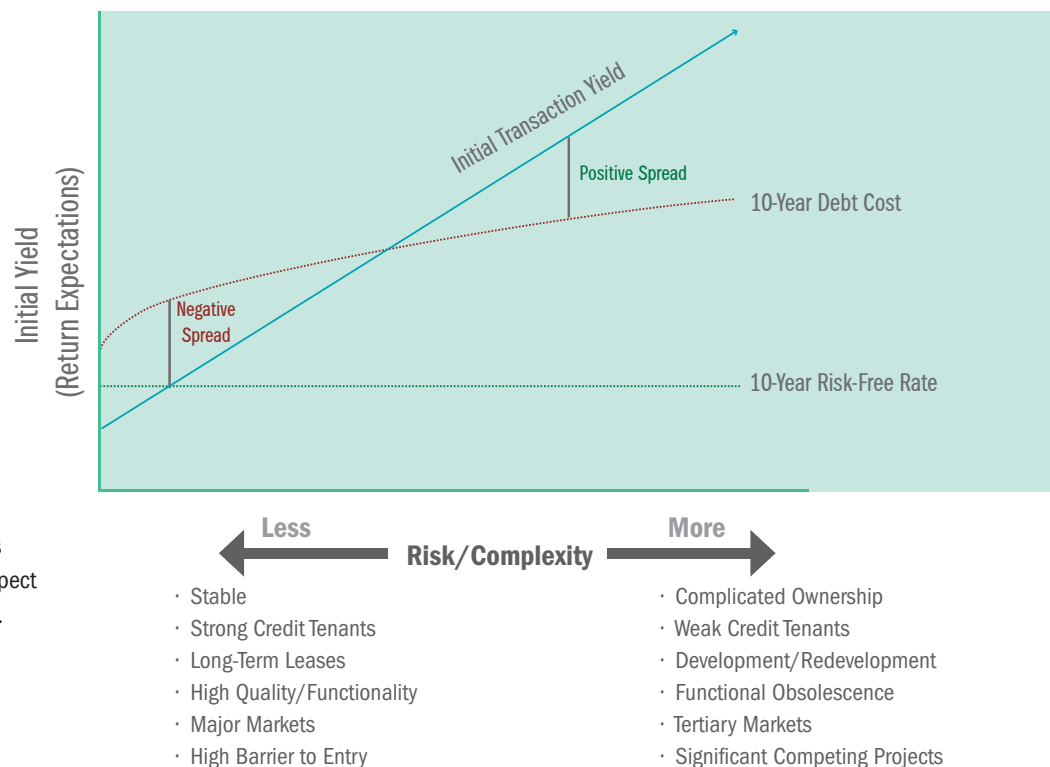
What has been the rationale behind investors making these investments at negative spreads?

One answer leads back to real estate fundamentals. Because of the significant focus on capital markets activity in the last few years, real estate fundamentals have been somewhat of a secondary consideration. Real estate fundamentals—the basic supply and demand equation for real estate driving rental rate dynamics—are thought to be improving in most major US cities. Will increasing rental rates allow property returns to expand to a level that creates a positive spread to the cost of financing? In many instances, properties are acquired with below-market rents that provide an opportunity for an increase as the leases turn. The fund sponsors count on this increase in their underwriting and bid accordingly.

Another possible rationale for negative spread investing is that some investors were betting on

The question comes more sharply into focus considering that many of the transactions in early 2007 were at yields that were below the cost of debt financing. This fact violates the long-established principle of positive spread investing, where additional risk is assumed by financing a portion of the purchase price of the asset acquired. As long as the return on the asset is greater than the cost of the financing, the return to the equity is amplified or leveraged. The risk associated with leverage is that the impact works in reverse when the yield on the asset is less than the cost of the financing. This negative spread investing is considered by many to be very risky. It is further complicated when one considers that the majority of survey respondents expect cap-rate expansion in the next 18 months.

Negative Spread Investing



Source: Ernst & Young



market momentum to lead to further cap-rate compression. Under this view, the analysis is not based on how the investors can increase rents/yield so much as whether the investors can simply sell some or all of the property to somebody else for even more than they paid for it. These investors were not buying to hold; they were buying to sell. Interviewees have analogized it to a game of musical chairs where the key is not to be left standing (i.e., holding these properties with yields below the cost of debt financing) when the music

stops (i.e., when the capital markets turn and cap rates expand).

Turmoil in the debt markets at the time of this writing (mid-2007) may have a tangible impact on this market momentum. The increase in credit spreads has broadly increased market rates for acquisition financing (see the US Debt Markets Snapshot below). Many factors have been cited as contributing to this widening of credit spreads, including the general slump in housing prices,

the dislocation of the subprime market, and a general view that underwriting standards in 2006 and prior had become too lax.

The cost and availability of debt capital is a critical component in the calculus associated with changing asset prices. A tougher loan underwriting environment, together with a general increase in the cost of debt capital, is likely to put significant pressure on the cap-rate compression trend of recent years.

US Debt Markets—Snapshot

The low cost and availability of debt capital has been widely reported as a significant factor in the prolonged period of market appreciation experienced in the real estate industry. In the US, as July turned to August, the flow of debt capital was reduced to a relative trickle, and the industry appeared to be holding its breath, waiting to see if the spigot would open again or tighten further.

Residential Market

On the residential front, the national slump in housing, coupled with increasingly aggressive loan structures, has led to escalating losses. Cumulative losses in the subprime space of up to 12% are widely expected for the 2006 vintage.¹ Concerns around subprime lending and a broad perception of overly soft underwriting standards in 2006 have dissipated the appetite for

investment in subordinate debt. As a result, spreads have increased significantly. As of early August 2007, BBB floaters have widened to LIBOR + 1000 basis points, a historically high level.² Further, as loan defaults increased and collateral values softened, lenders have started to call warehouse credit lines, forcing loan originators and other finance companies to sell assets into a softening market at reduced prices. These factors put pressure on lenders of all sizes, and those lenders that were poorly capitalized and perhaps less disciplined became quick candidates for insolvency.

Rating agencies have reportedly stepped up their rating metrics, resulting in a round of downgrades on bonds backed by subprime loans and a slowing of the securitization market to what by historical standards is just a trickle. Some lenders have reportedly stopped underwriting all but

the most straightforward, traditional loans.

Commercial Market

Although commercial real estate fundamentals continue to improve and the cumulative default experience of commercial mortgage securities remains at a low 2.4%,³ the commercial mortgage business has been significantly impacted as well. In the second quarter of 2007, investors balked at what they perceived was aggressive underwriting, and by the third quarter, those same investors were demanding higher yields for all classes of commercial mortgage-backed securities (CMBS). The 10-year spread over swaps for fixed rate AAA CMBS more than doubled from June to July.⁴ Many investors are waiting on the sidelines for spreads to settle. As a result, monthly issuances of US CMBS in July were less

than half the volume reported for June.⁵

The resulting liquidity crunch caused by this investment pullback will make it more difficult for funds to finance their acquisition pipeline in the future. The leverage enjoyed by real estate investors in the past is likely to be curtailed. Of course, this trend has the contrarians of the investment community buzzing. The liquidity issues of today may very well result in the opportunistic investments of tomorrow. It has been widely reported that some fund sponsors are building up their war chests to take advantage of the opportunities that this market illiquidity may present in the months to come.

¹ JPMorgan, *Global ABS/CDO Weekly Market Snapshot*, 7 September 2007.

² *Ibid.*

³ Standard & Poor's, *North American CMBS Default and Loss Study*, 2 August 2007.

⁴ *Commercial Mortgage Alert*, 27 July 2007.

⁵ *Ibid.*

Investment Dispersion and a Dichotomy

Our survey respondents' investment dispersion reflects a dichotomy based on fund size.

- Smaller funds in the US\$200–\$500 million category are more heavily weighted domestically, with 91% of equity raised by fund managers targeted for investment in the US.
- Larger funds with capital greater than US\$500 million have a much more significant weighting outside of the US with 31% of investment capital allocated to Europe and Asia.

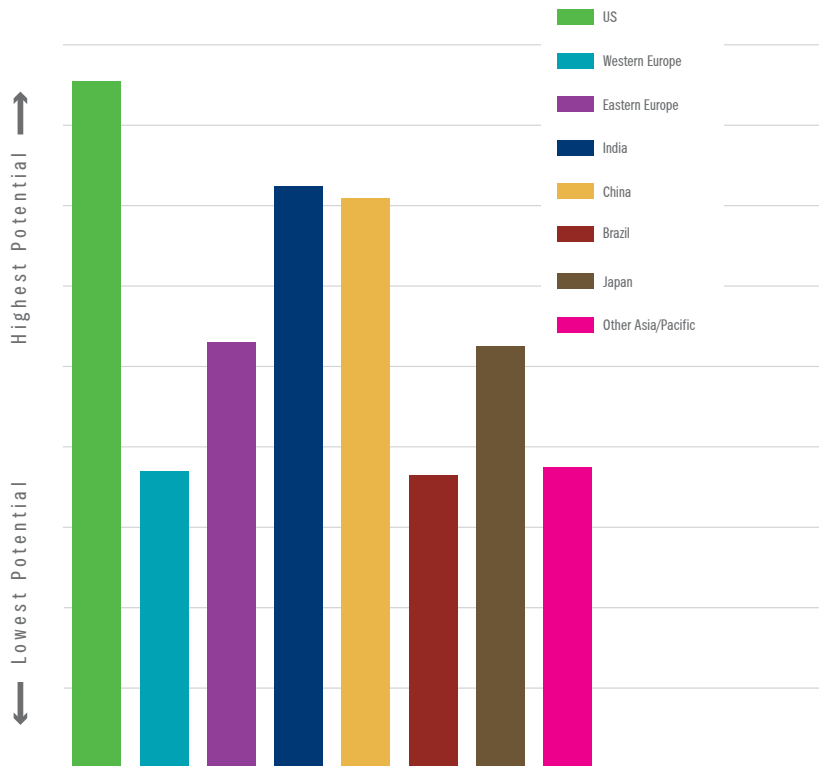
More than 90% of our survey respondents believe that improving real estate fundamentals will drive net operating income (NOI) increases in excess of the inflation rate. However, as noted earlier, 71% of our respondents believe that cap rates are likely to expand for the balance of 2007 and 2008. These factors create a dynamic tension across the real estate landscape.

Since NOI growth and market capitalization rates are two primary drivers of real estate value, and they are expected to move in opposite directions for the balance of 2007 and 2008, a question emerges: Which of these two factors will have the more dramatic impact on real estate values?

We asked our survey participants if the impact of strengthening fundamentals on NOI will have a greater impact on property values than expanding cap rates. The answer varied by region.

- For investment in Asia, 59% of our respondents believe that NOI changes will be dominant, and property values will increase for the balance of 2007 and 2008.
- 47% of the respondents felt the same way about property values in the US, with 38% believing that these factors will effectively offset each other, and property values will be largely unchanged.
- With respect to Europe, only 41% of investors felt that property values would rise, with 59% having the view that property values will flatten out or decline.

Global Real Estate Markets Ranked According to Risk-Adjusted Return Potential



Source: Ernst & Young

Risk and Reward Across the Global Landscape: a REIT Expansion

After the US, India and China are the two markets that our respondents believe have the highest risk-adjusted return potential. Investors in these and other developing markets are quick to point out that it is critically important to have experienced local resources on the ground to protect a fund's interests. One interviewee noted wryly that first-time investors who travel to China for one week and come back to the US to tell their partners they are "OK to invest in China" may have a bit more due diligence to do.

The last several years have seen the development of US-style real estate investment trust (REIT) legislation in many locations throughout Asia, South America, and Europe, including Germany, the UK, and Italy in 2007. Nearly half of the global funds responding to our survey indicated that this broadening REIT legislation around the

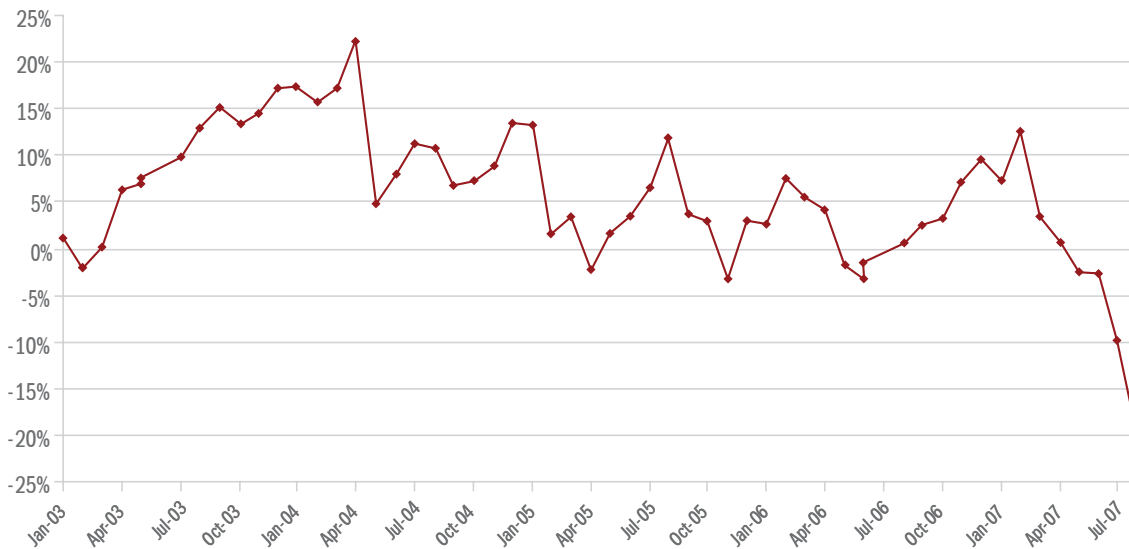
world would increase the overall potential for 20% investment returns. While the legislation is still in its infancy in many locations, these new vehicles may increase monetization opportunities in countries like Japan, where public REITs may purchase stabilized assets once the funds have executed their investment strategies. In Italy, for example, prior legislation was only targeted to privately held REIT vehicles, while the new legislation, approved in July 2007, is specifically targeted at publicly traded REIT vehicles, potentially opening investment opportunities to a whole new class of investors.

US REITs have been a popular target for real estate private equity funds. Public-to-private deals have dominated a good portion of the coverage in trade journals over the last two years, with more than 50 transactions since the beginning of 2005. More than 40% of these transactions involved a real estate private equity fund purchasing the REIT.⁶

⁶ "M&A Statistics Deal Listing," SNL Financial Website, <http://www.snl.com/interactivex/IS_MAGraph.aspx, accessed 5 July 2007>.



REIT Share Price Premiums to Green Street Net Asset Value Estimates



Source: Green Street Advisors

These REIT acquisitions have generally been large transactions at premiums to the existing market price of the public shares. Implicit in these trades is the notion that the REITs and their portfolios are undervalued on Wall Street.

Interestingly, equity REITs have historically targeted total returns generally in the range of 7% to 12%, and real estate private equity funds with an implicit 20% return expectation are acquiring these companies at a premium. While increased leverage plays a large part in amplifying the returns on these public-to-private deals, there is some debate as to whether the change in management focus also plays a big part. There is a certain irony to the notion that a finite-life real estate private equity fund, many of which are run by former high-flying Wall Street traders, will take a long-term view and make perhaps tougher short-term management decisions than the more conservative perpetual-life equity REITs, which seem burdened by making the quarter-to-quarter earnings targets of analysts.

Asset Class Composition: the Development of Infrastructure

According to our survey participants, the four basic real estate asset classes—office, multi-family, retail, and industrial—are still attracting the majority of investment capital from our survey participants, with office taking the clear lead. However, other asset classes, such as hospitality and infrastructure, seem to be gaining momentum.

Much has been written about the infrastructure issues facing the public sector worldwide as the costs of building, improving, maintaining, and operating infrastructure are substantial and continue to grow. Along with other private investors, real estate private equity funds are helping to answer the question of how to pay for the costs of infrastructure development, repair, and upgrade.

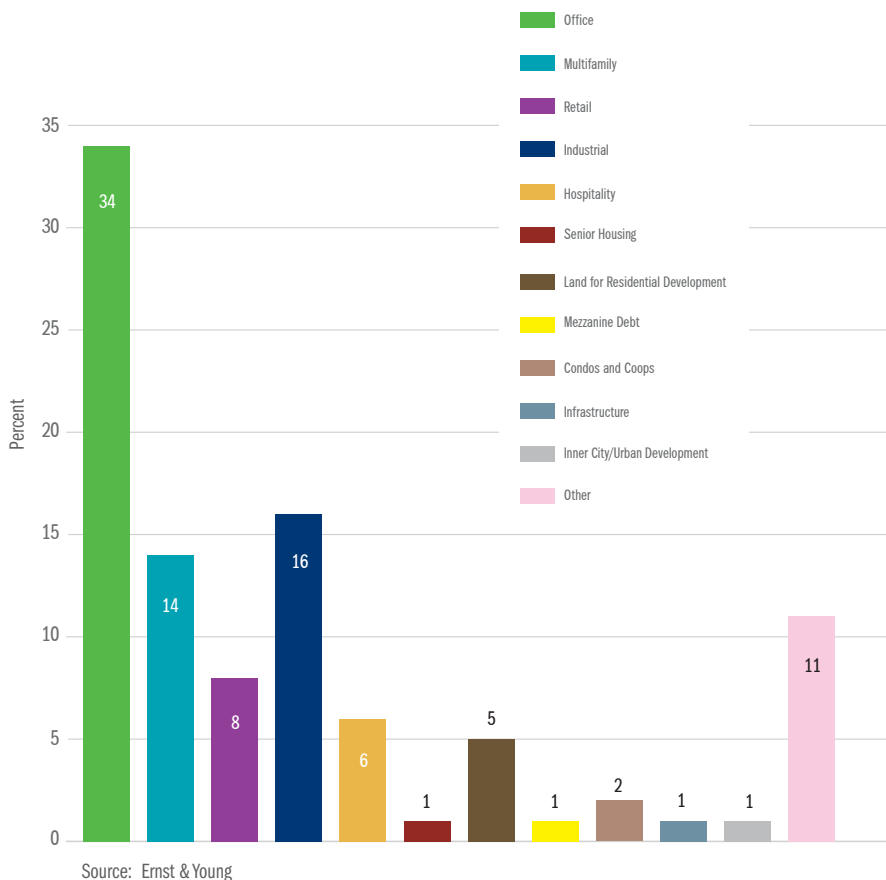
The result? A convergence of public sector demand for capital and private investment capital in search of yield. Infrastructure fund investment vehicles, with a view toward developing or acquiring infrastructure assets such as ports, toll roads, bridges, and tunnels, are blossoming. However, although private capital currently flowing into infrastructure is substantial, anecdotal evidence suggests it is dwarfed by the potential size of this market.

As with other asset classes, the flood of capital in this area has significantly increased competition, especially in mature markets such as Western Europe where private investment in infrastructure has been popular for some time. Not surprisingly, this competition for investment opportunities in mature markets has generally increased prices and decreased yields. The US—definitely not a mature market—has been a relative laggard with respect to public-to-private infrastructure investment when compared to Western Europe, Canada, and Australia. Over 75% of our survey respondents indicated that the opportunistic return potential for infrastructure investments is fair or better.

Value Creation

In today's highly competitive environment, the greatest differentiator between 2007 vintage funds that eventually realize mediocre results and those that fully meet and exceed return expectations may be evidenced in the value creation portion of the fund life cycle. By historical standards, there has been little, if any, thematic under-pricing of real estate in most markets today. The potential impact of the current turmoil in the debt markets notwithstanding, the opportunity to buy well out of distressed circumstances has been fairly limited until now.

Asset-Type Composition



Further, the significant cap-rate compression over the last several years may be coming to an end. Although few market participants would wish for a shift in pricing momentum, the majority of our survey participants are underwriting a cap-rate expansion in the next 12 to 18 months. In the face of a cap-rate expansion, conventional wisdom suggests that the only way to enhance property values is to increase cash flow.

Successful fund sponsors will be creative in finding new investment opportunities and will have a definitive post-acquisition strategy for value creation. The ability to manage risk and work through complexity is critical. Converting unattractive, cumbersome, high-risk assets that may be unsuited to the standard institutional investor into fully leased, stable, cash-flowing properties genuinely creates value for investors. Redeveloping, retenanting, repositioning, and working through difficult legal and structural barriers are part of the daily activities of the opportunistic investor in the value-cre-

ation phase. As noted in the chart on the following page, when asked which value-creation scheme was preferred within their organizations, 62% of our survey respondents indicated that managing the risks associated with asset development is part of their favored value-creation scheme.

The value-creation portion of the real estate fund life cycle clearly highlights how important the right management team is to the long-term success of a real estate private equity fund. Our survey participants were nearly unanimous: 98% said that selecting the right fund manager is more important in today's market than it was three years ago.

As the capital markets shift, finding a management team that will continue to perform when the tide of capital is not rising will be critical for the next generation of funds. Those that search well and perform their diligence on fund management will likely be rewarded for the effort.

Investment Monetization

Increased Liquidity and a Shorter Cycle

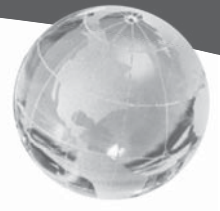
The significant liquidity in the market, which was fueling the competition to acquire properties, has been ideal for fund sponsors in the monetization portion of their fund's life cycle. Through the first half of 2007, it was not uncommon for fund sponsors to have multiple unsolicited bidders for their properties, and their demands for shorter and shorter diligence periods were most often met.

This level of investment demand had boosted the pricing of asset sales to levels at or near historical highs. As shown in the table on the following page, over 90% of our survey participants' investments were tracking at or above return expectations at original underwriting. However, in light of the general sentiment that cap rates are likely to expand in the next 12 to 18 months, investment cycle times from underwriting to monetization have been trending shorter and shorter.

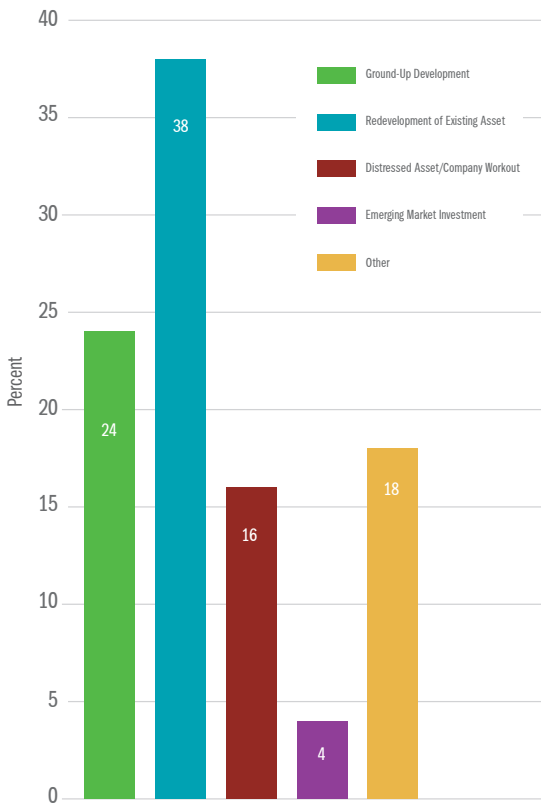
In our survey, 68% of respondents indicated that the pace of asset dispositions increased in 2006, and more than 70% expected a further increase in 2007. Based upon our interviews, we learned that many of these funds were selling assets ahead of their original business plans as the opportunity to lock in returns and take the market risk off the table was too attractive to pass up.

The latest twist to these short cycle times is the concurrent sale or "flipping" of a portion of a portfolio immediately following the closing of the portfolio acquisition. With respect to certain public-to-private deals, the flipping or immediate sale of a portion of the REIT portfolio upon closing of the acquisition has garnered significant attention. In several high-profile transactions, Blackstone has reportedly sold off properties from the Equity Office portfolio for gross proceeds in excess of US\$27 billion, which is more than 70% of the US\$39 billion Equity Office purchase price.⁷

⁷ Jennifer S. Forsythe, "Blackstone's Slick Flip," *The Wall Street Journal* 26 July 2007.

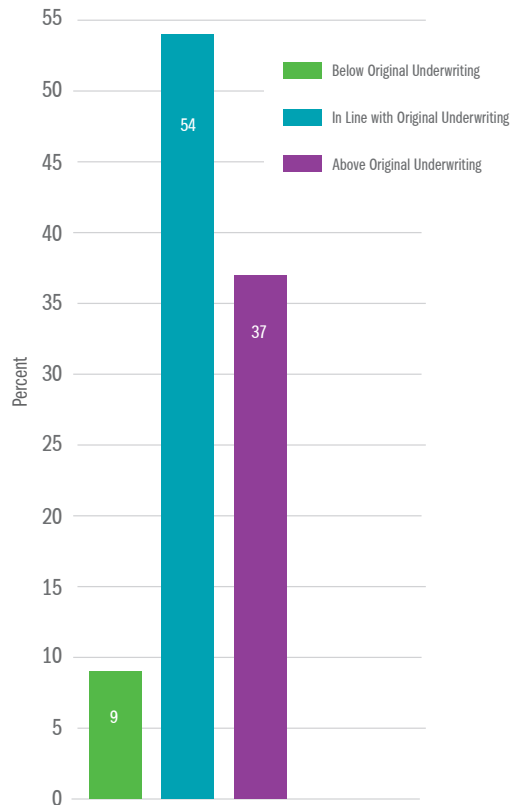


Favored Value Creation Scheme in 2006/2007



Source: Ernst & Young

Performance Returns: Percentage of Current Fund Assets Tracking



Source: Ernst & Young

Of course, the accelerated monetization of a fund portfolio inevitably puts the fund sponsor back into the beginning of the cycle, managing the risks associated with raising and deploying capital.

The rapidly shifting landscape fueled by the turmoil in current debt markets is likely to create challenges for real estate fund sponsors. The widening of credit spreads has put downward pressure on asset valuations in general. As noted earlier, having a seasoned management team to lead and take advantage of the market challenges and opportunities ahead would seem to be the order of the day.

Global Perspectives

The following are high-level market insight summaries from Ernst & Young real estate fund professionals in various countries around the world.

Australia

In recent years, the dearth of available investment grade property in Australia has led to the establishment of a number of private funds focused on offshore investment.

The listed property trust (LPT) sector is also now embracing the private fund market. The LPTs are looking to free up capital and generate new income streams by moving assets off their balance sheets and into separate funds that they manage for outside investors.

Growth in the private fund sector is likely to continue as Australia's workers are required to contribute 9% of their wages to superannuation (pension) funds, a portion of which will continue to flow to real estate.

China

Over the last several years, as China has opened its doors to investment, billions of US dollars of capital from real estate private equity funds have been invested in real estate projects throughout the country. These investments include residential projects in developing areas and large cities, as well as retail and office projects throughout the country.

In July 2007, the State Administration of Foreign Exchange of China (SAFE) imposed restrictions on foreign debts for foreign investors in real estate projects. Under this new rule, foreign investors would either have to fund the project with 100% equity (i.e., without any leverage) or arrange for a Renminbi-(RMB) denominated loan. Such loans may not be immediately available until all the certificates for project development have been obtained. Therefore, under this new rule, foreign real estate investors may face greater obstacles financing and capitalizing their projects.

Germany

In 2006, real estate transaction volume soared and, based on the first half of 2007, it is expected that 2007 transaction volume will reach comparable heights.

The introduction of commercial property REITs in Germany is expected to further invigorate the transaction market. Also, through the introduction of listed real estate vehicles, the real estate market is likely to become more transparent and therefore more attractive for a broader population of potential buyers.

India

The Indian real estate sector has witnessed momentous growth over the past two years. Sustained high gross domestic product growth, an upsurge in industrial activity, rapid urbanization, and favorable regulatory changes are some of the factors that are fueling this growth; further, the increasing integration of the Indian economy with the global economy has also led to an increase in corporate activities which, in turn, has significantly increased the demand for commercial and retail space in the country.

Potential investment returns in excess of 20% have drawn investment funds to India. The initiatives taken by the government of India towards liberalizing the regulations relating to foreign direct investment in construction and development projects, and the creation of more Special Economic Zones (SEZs), have resulted in increased investment in the real estate sector.⁸

Over 75 foreign investors are already in the country tapping investment avenues. It is estimated that US\$10 billion of foreign investment will be injected into the Indian real estate sector in the next 12 to 18 months, including nearly two dozen US funds raising US\$3.5 billion for investments in Indian real estate. Private equity funds from other countries are also lining up to invest.⁹ Some have taken positions for fund of fund investments, and others are engaging advisors to carry out their investment strategies. With over 30 Indian cities having a population of 1 million or more, India should remain a strong contender for real estate private equity investment for years to come.

Japan

After many years, Japan's land prices are increasing. Japanese funds see real estate as a relatively safe investment that offers competitive returns and an opportunity for portfolio diversification. Compared with the global funds, Japanese funds are generally smaller, typically in the ¥30 billion (US\$250 million) to ¥60 billion (US\$500 million) range, and their transaction volume is lower. They also tend to invest for slightly longer periods, typically in the seven-to-ten-year range.

Return expectations for domestic Japanese funds are generally 10% to 15%, which is competitive with alternative investments in the domestic market. Japanese funds are also becoming more global, exploring opportunities not only in Japan and elsewhere in Asia, but worldwide.

Luxembourg

More funds have been started in Luxembourg than in many other European countries, a trend expected to continue well into the future. Luxembourg is a popular venue, in part because it offers a flexible regime for creating customized, tax-efficient investment vehicles.

There are more than 100 Luxembourg-based real estate funds, generally ranging in size between €200 million (US\$270 million) and €1 billion (US\$1.4 billion) or more in target capitalization.¹⁰ Of these funds, about two-thirds are regulated. The number of regulated funds is growing due to a flexible investment-fund regime introduced in early 2007.

The Netherlands

Some of the Netherlands' real estate private equity funds are global leaders in raising and investing capital worldwide. Global funds are becoming more creative, looking beyond traditional assets and markets to other opportunities. These opportunities include emerging markets and investments in infrastructure, whether through companies that directly own infrastructure or in public-private partnerships between governments and private companies to build, own, and operate infrastructure such as toll roads and railroads.

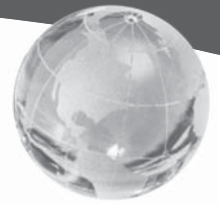
UK

In the highly competitive UK market, there are fewer opportunities for real estate private equity funds to make the stellar returns that were realized in the past. As a result, UK real estate funds have expanded their investment focus globally. The effects of the subprime crisis in the US and the consequent credit crunch are being felt in the UK and European real estate markets. Buyers have difficulty finding the debt capital to create the leverage of the recent past. On the other hand, purchase prices are coming down in the face of market uncertainty.

⁸ Jones Lang LaSalle, *Economic Insight: India*, May 2007.

⁹ Ibid.

¹⁰ Association of The Luxembourg Fund Industry, September 2007.



Other Industry Developments

Taxation of Carried Interests

A legislative proposal introduced by US representatives Sander Levin (Democrat-Michigan), Charles Rangel (Democrat-New York), and Barney Frank (Democrat-Massachusetts) in June 2007 would, if enacted in its current form, significantly affect the current taxation of partners holding a “carried interest” in a fund or other partnership.

A carried interest in a fund entitles the sponsor to a special allocation of fund profits, usually 20%, after the fund investors have achieved a specified return hurdle. A carried interest contributes to an alignment of interests between the fund sponsor and passive fund investors by providing an incentive for the sponsor to generate fund profit.

Under current law, carried interests are not taxable when issued because they represent an interest in a fund’s future profits and not a share of the existing fund capital. Additionally, the character of income ultimately realized by the carried-interest holder is based on the character of the fund’s income. Thus, if the income generated by the fund represents capital gains, then the carried-interest holder’s allocated share of the income will be characterized as capital gains and, therefore, taxable at capital gains rates.

The Levin, Rangel, and Frank proposal would tax at least a portion of the income recognized through the carried interest—to the extent that interest was received for services—at ordinary rates. Income distributions from a fund representing a return on invested capital would retain the character of the fund’s earnings, including capital gains. However, the proposed statute does not describe how to determine how much of a carried-interest allocation is related to services rendered as opposed to a return on invested capital.

The carried-interest model is widely used in the real estate industry and the broader private equity business. The recharacterization of what are currently capital gain allocations (taxed to individuals at a 15% rate) to ordinary income (taxed at a 35% rate) is seen in the US Congress to have significant revenue-raising potential. Since the issuance of points to fund employees in a fund sponsor’s carried interest is a major compensation tool used to provide incentives for performance, this proposal, if enacted into law, could significantly impact the after-tax compensation within the industry.

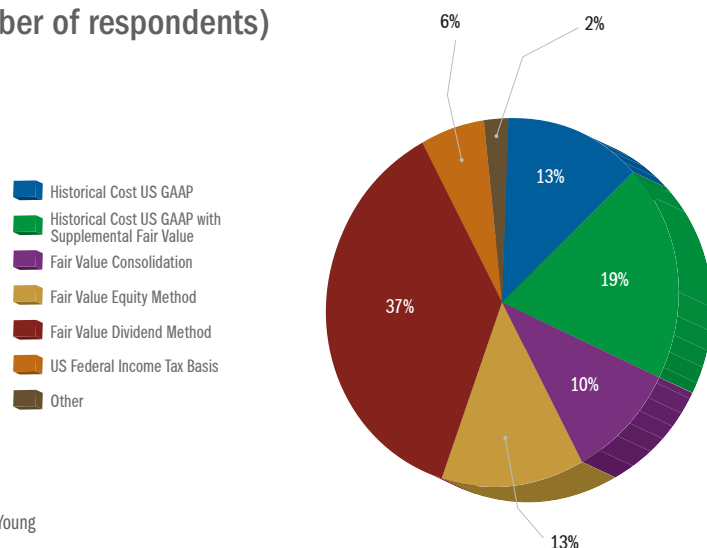
Because the significant growth enjoyed by the real estate fund sector has helped fuel increased competition for talent, the connection between outstanding fund performance and a deeply talented and highly motivated management team is hard to refute. Since one of the significant compensation tools used to attract talent has been the issuance of points to management employees, the legislation, if enacted, could have an impact on the industry’s ability to attract and retain the best and the brightest real estate professionals.

Accounting and Reporting—Investment Companies

Fund Level Reporting

As in prior reports, we asked our survey participants “What basis of reporting is utilized in presenting your most recent fund’s annual financial statements?” As demonstrated in the following chart, in the US alone, six different reporting methodologies were identified, including three different methods of reporting on a fair value basis and two additional US methods (federal income tax and historical cost generally accepted accounting procedures [GAAP]) that generally ignore investment appreciation, but instead reflect annual charges for depreciation. Clearly, this situation makes comparability between funds difficult.

Method of Financial Statement Reporting (by number of respondents)



Source: Ernst & Young

In June 2007, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position 07-1 *Clarification of the Scope of the Audit and Accounting Guide: Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (SOP 07-1). As a result of this new guidance, a fund meeting the criteria of an investment company will be required to use the fair value accounting principles of the AICPA's Audit and Accounting Guide *Investment Companies* (the Guide) in order to comply with US GAAP. If a real estate fund does not fall within the definition of an investment company, then its US GAAP financial statements will be historical cost, which is generally the method used by real estate operating companies today. All funds and other real estate companies, including private REITs that were previously precluded from applying investment company accounting, will be required to re-evaluate their accounting model and determine whether or not they qualify as an investment company within the scope of SOP 07-1. Since accounting for entities identified as investment companies is not elective, there could be significant changes in the presentation of financial statements.

In order to qualify as an investment company under SOP 07-1, a fund must meet certain business purpose and activities requirements, the key elements of which have been summarized in the adjacent table. SOP 07-1 also provides additional factors to consider in making this determination. No single factor is determinative; each of the factors must be evaluated and considered in determining whether the entity is an investment company. Operating companies and entities that make investments for strategic operating purposes do not qualify as investment companies.

Do You Qualify as an Investment Company?

Required Characteristics	Investment Company Attributes
Entity type	Must be a separate legal entity
Expressed business purpose	Must invest for current income, capital appreciation, or both
Entity's activities, assets, and liabilities	No substantive activities, assets, or liabilities other than its investment activities
Identification of exit strategies	Investment plans must include identification of exit strategies and expected holding period for each investment
Number of investments	Multiple substantive investments

Other Factors to Consider	Investment Company Attributes
Number of substantive investors	Multiple (pooling of funds)
Level of ownership of investees	Low
Ownership by passive investors	Substantial ownership by passive investors
Ownership by employee benefit plans	Substantial ownership by employee benefit plans
Level of involvement in day-to-day management of investees	Limited involvement in day-to-day management of investees
Level of administrative or support services provided to investees	Limited administrative or support services provided to investees
Guarantee arrangements	Investees do not provide financing guarantees or assets to serve as collateral for borrowing arrangements of the entity.
Lending activities	The issuing of loans by non-investment company affiliates to investees may be inconsistent with the definition of an investment company.
Compensation of management or employees of investees	May not be dependent on the financial results of the entity or its affiliates
Business relationships between investees	Limited directing of the integration of operations of investees or their affiliates or the establishment of business relationships between investees or their affiliates

Source: Ernst & Young



Fund Sponsors and Other Investors

SOP 07-1 also provides guidance for determining whether the specialized investment company accounting should be retained in the financial statements of a parent company or an equity method investor, which is a significant change from current guidance. This guidance assists in evaluating the relationships between the parent company or equity method investor and the entity's investees to determine if the investees are autonomous businesses, separate from the parent company or equity method investor. As with the determination of whether or not a fund is an investment company, the SOP includes multiple factors to assist in determining whether the accounting should be retained.

If it is determined that investment company accounting cannot be retained, the financial information of the investment company would need to be adjusted as if investment company accounting had not been applied for purposes of the consolidated financial statements of the parent company or equity method investor. This could potentially result in the need for two sets of accounting records for the fund: one to report to investors and one to prepare the financial statements of the parent company, fund sponsor, or equity method investors.

Timing and Transition

SOP 07-1 is effective for fiscal years beginning on or after 15 December 2007 (i.e., calendar year 2008). Entities that previously applied investment-company accounting but are no longer permitted to use this reporting model should adopt the historical cost model prospectively. Entities that did not previously apply investment-company accounting, but are determined to be investment companies based on the provisions of SOP 07-1, should report the cumulative effect of adoption as an adjustment to opening retained earnings as of the beginning of the year of adoption.

Determining whether an entity qualifies as an investment company will require a considerable use of judgment. Since this determination could have a significant impact on the financial report-

ing model used by an entity, it is generally recommended that this evaluation be made sooner rather than later, with adequate time to plan if a change in reporting is needed.

Fair Value Reporting Option

Although SOP 07-1 may potentially preclude certain funds and fund sponsors from retaining the specialized fair value-based accounting model for investment companies, the Financial Accounting Standards Board (FASB) has issued new guidance that, in theory, allows for broader use of fair value accounting for investments.

In February 2007, the FASB issued statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FASB 159). This permits a company to elect to measure certain financial instruments, including equity method investments in unconsolidated investees, at their estimated fair values at each balance-sheet date, with the changes in fair value reflected as a component of income in the period of change. In accordance with FASB 157, fair value is the price to sell an asset or transfer a liability, i.e., the exit price, and not the transaction or entry price.

This election is made on an instrument-by-instrument basis at the time of adoption of FASB 159, initial investment, or in certain special circumstances such as the time that investment-company accounting is discontinued as a result of the provisions of SOP 07-1. Accordingly, those funds or fund sponsors that no longer qualify to retain the specialized accounting of investment companies may elect, in theory, to apply the provisions of FASB 159 and report their unconsolidated equity method investments at fair value. However, for fund sponsors and other entities that are entitled to a carried interest as well as a capital interest in a fund, there is a potential complication.

We are aware that the staffs of the Securities and Exchange Commission (SEC) and FASB have recently provided informal guidance that in certain situations, a general partner may not elect to mea-

sure its interest at fair value in accordance with FASB 159. More specifically, this informal guidance suggested that a general partner's carried interest may not be measured at fair value if that general partner is required to perform substantive future services, because to do so would result in premature revenue recognition. That is, by measuring the general partner's investment at fair value—which typically includes the right to receive carried interest—the general partner would be able to recognize income immediately. Moreover, because FASB 159 states that the fair value election must be applied to all of an instrument's features—not only portions of it—this informal guidance would appear to preclude the general partner interest from qualifying for a fair value election under FASB 159.

This informal guidance could impact general partners and other equity method investors in many industries, including real estate and private equity. Clarifying guidance is being sought from the FASB staff, but it is unclear at this time whether additional guidance will be forthcoming and, if so, what form that guidance might take. Readers should closely monitor developments in this area.

Accounting for Income Taxes

In 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). Effective 1 January 2007, FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. This guidance applies to all positions related to income taxes, including tax positions considered routine and those containing a high degree of uncertainty. FIN 48 is broadly applicable to most entities including pass-through entities, non-taxable entities, and entities whose tax liability is subject to a 100% credit for dividends paid (e.g., US REITs and registered investment companies).

Under FIN 48, entities such as real estate private equity funds will be required to inventory and evaluate all of their tax positions. FIN 48 utilizes a

two-step approach for such evaluations. An entity first determines whether a tax position, based solely on its technical merits, with all facts known to all parties, is more likely than not to be sustained upon examination. If the tax position meets this standard, the entity measures the tax benefit as the largest amount of benefit that is more likely than not to be realized upon ultimate settlement.

Given the complexity of the existing structures used by many real estate private equity funds—particularly those involving global investments and those made utilizing private REITs—conducting an inventory and evaluating the tax positions of all consolidated affiliates could be time consuming. Additionally, although the structure may have a high likelihood of being sustained if executed as intended, there may be procedural requirements that have been neglected over time in maintaining an existing structure. Failure to adequately monitor the maintenance of a structure could invalidate a portion of the structure and result in a requirement for a tax provision in accordance with FIN 48.

It is generally recommended that fund sponsors create a process to document new tax positions while regularly monitoring existing positions. Such a process will ensure that there are no surprises when applying the provisions of FIN 48 in the preparation of their fund's financial statements.

Initial Public Offerings

Historically, the fund-sponsor community has been characterized as relatively closed off from public observation, preferring to keep its business private. At various times over the past decade, calls by investor groups and industry pundits for more transparency have not been widely acknowledged. The fund sponsors have let their consistently high returns speak for themselves.

Against this backdrop, the recent trend of alternative-asset managers filing to go public is very interesting. Moving from a closely held organization, where the confidentiality of operations and results are tightly controlled, to the public

arena, which has been most often described as “operating in a fish bowl,” is a huge transition. Why would a successful alternative-asset manager consider such a course of action?

The business purpose discussed in the public filings of some large private equity/hedge fund managers has had fairly consistent themes:

- To access new sources of capital that can be used to expand their existing businesses and enter into new businesses
- To enhance flexibility by using publicly traded stock as currency in transactions
- To expand the incentives that can be provided to current and future employees
- To permit the realization over time of value by the existing owners.

Through mid-year 2007, none of the real estate private equity fund sponsors have followed with their own filings. However, given the influence of these large alternative-asset managers, if their efforts in the public arena prove to be successful, the trend may spill over into real estate.

One hurdle that would have to be overcome is the shifting tax landscape. Most of the alternative-asset managers filing for public listings have done so as publicly traded partnerships (PTPs). Under the PTP structure, as long as 90% of an entity's gross income is generated from passive sources, the PTP is treated as a partnership, and the taxable income and other tax attributes flow through to the public share- or unit-holders. In the PTP structure, non-passive income is generally earned through a taxable corporation.

In June 2007, US Senators Max Baucus (Democrat-Montana) and Chuck Grassley (Republican-Iowa) introduced a legislative proposal that would effectively tax a PTP as a corporation, to the extent it derived income from a carried interest in a fund it was managing. As with the proposed legislation by US Representatives Levin, Rangel, and Frank, certain industry leaders are making an effort to combat the thinking behind this proposal. However, it is unclear what the ultimate outcome will be.

The process of transforming an organization to a public company is long, complicated, and expensive. The burdens associated with subjecting an organization to regulation and daily public scrutiny cannot be measured in dollar terms. Some very well-regarded companies, however, have opted to make this trade. Those fund sponsors considering this option should carefully weigh the monetary and non-monetary costs to ensure they are fully committed to the process. As we have said to all who have approached us for assistance in the IPO journey, it is almost never a good idea to file to be a public company on a hunch.

A View from the Back Office

As the real estate private equity fund market has matured, one could argue that the level of back-office support has not universally kept pace and may be inconsistent with the billions of dollars of assets under management. Additionally, in uncertain times, such as those caused by the turmoil in the debt market, expenditures on what is perceived as “overhead” are among the first areas where cost reductions occur.

There are several factors impacting a fund sponsor's ability to report to investors on a timely basis. Many funds are highly dependent on third parties (such as joint-venture partners or property managers) for gathering and reporting critical financial and tax information. These third parties often use antiquated or weak operational processes, which impact both the quality and timeliness of their reporting to the fund. Further complicating the timeliness of the fund's reporting to investors are inconsistencies between the processes for gathering and consolidating data from third parties and the internal processes utilized by the fund to funnel data through its organization.



Quips and Quotes

On the conference circuit and during the course of our interviews, fund sponsors were open and candid about the industry. The following anonymous quips and quotes serve as a reminder that the real estate fund landscape takes on a different appearance depending on where you stand and how long you have been there.

“Everyone has a fund now..”

“Making a winning bid at a full-price real estate auction today is a triumph of dumbness.”

“It’s the late stages of a momentum market.”

“There’s a real arbitrage between how operating companies are being valued and how real estate is being valued.”

“If rates jump up 200 basis points, it’s all over.”

“In 2006, there was no underwriting discipline.”

“Lenders are really agents; if they can sell it, they will underwrite it.”

“If there is a downturn, it will take the inexperienced players out of the market...then it will get fun again.”

“We’re looking for ‘next markets.’”

On emerging markets, “We don’t want to be first, but look to be the fastest second in the market.”

“It’s choppy waters the next three to four years if valuations revert back to the historical mean.”

“We get paid for performance...if we do well, the capital will be there; if we don’t, the money should move elsewhere.”

“Asking real estate fund sponsors if they can still achieve 20% returns investing in the US is like asking the Chamber of Commerce in Orlando if it ever rains at Disney World.”

On cycle times, “Twelve months is almost a long time these days.”

Transparency

Most real estate private equity funds are fielding requests for an enhanced level of fund transparency. There is an increased demand for specific reporting requirements from an investor community that has become more cognizant of appropriate levels of controls and wary about any perceived control weaknesses.

International Scalability

Many funds are looking to international markets for their future growth. Pursuing an international growth strategy drives the imperative to have the right infrastructure in place to handle the higher degree of complexity required to conduct business abroad. Such complexity includes managing currency exchange risk, coping with cultural and lan-

guage differences, understanding varying business practices, and managing differing perceptions of timely and accurate reporting.

Technology

Inadequate or obsolete technology for managing daily operations has the potential to result in incremental risk for a real estate fund. As an example, many funds typically use common spreadsheet programs to create complex “waterfall models” that are used to determine how equity should be distributed to the various investors, often with different and complex ownership stakes. Software vendors that specialize in the private equity real estate space have been mediocre at best in deploying leading-edge tools to help funds address and manage their complex needs. Some existing off-the-shelf solutions are finally

just beginning to mature to the level required to support the industry’s changing requirements.

The Future

The seeds for future development are apparent today. Leading funds in the industry are scaling for growth. They are aligning their organizational structure, business processes, and technology to support their overall strategies. They are strengthening internal controls to mitigate the possibility of error or fraud. Funds that fail to place greater rigor around these areas may be more susceptible to investor reporting issues. Having the right infrastructure in place, with the necessary flexibility and adaptability built in, may provide a competitive advantage in the future.

Developing This Report

Ernst & Young's 2007 *Market Outlook: Trends in the Real Estate Private Equity Industry* marks the fourth report in our series providing a comprehensive summary of the trends and developments in the real estate private equity fund sector. This report covers market, capital, and investment trends and explores their effect on the real estate fund life cycle. It is based upon data collected and analyzed by Ernst & Young professionals dedicated to the real estate private equity fund industry.

As in the past, the central part of our research is a survey of real estate private equity fund sponsors primarily based in the US, which focuses on the value-added and opportunistic end of the investment spectrum. Our survey included 25 questions focused on the different phases of the real estate fund life cycle. We received responses from fund sponsors representing 285 funds with aggregate capital of US\$172 billion. We also conducted a series of interviews with sponsors and other market participants to supplement the survey findings and our general observations of the market.

The survey data in the report were based upon responses received by 1 August 2007 and performance data that are largely based on fund results through the end of 2006.

Ernst & Young has maintained the strict confidentiality of all survey respondents and interview participants. Under no circumstances will the identity of the respondents or those interviewed be made public.

In preparing this report, Ernst & Young relied on the data and information supplied by the survey respondents. We did not attempt to verify the information provided in the survey or interview process, and we do not take responsibility for the accuracy or reliability of the data. In some instances, historical data are based upon current and prior survey responses, with current responses taking precedence in case of conflict.

Acknowledgements

The report is the culmination of months of data accumulation and analysis. Our special thanks to Dovid Frankel and Jill Maguire for their passion, energy, and drive in seeing it through to completion.

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About Ernst & Young's Real Estate Fund Services Group

Ernst & Young has invested in the people, processes, tools, and methodologies required to help meet the challenges faced by real estate private equity funds. Our Real Estate Private Equity Fund Services Group is an international team of senior real estate professionals experienced in providing multi-disciplinary services to funds.

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