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2010 Preqin Global Real Estate Report

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Keynote Address - Mitchell B. Sikora, MVision Private Equity Advisers

Interview with Mitchell B. Sikora, Managing Director, MVision Private Equity Advisers

Interview conducted by Tim Friedman, 11/01/2010

TF: Private equity real estate has come through a difficult patch over the past few years. We've seen fundraising falling away and performance dropping – albeit after some very good years for investors. How are investors feeling towards private equity real estate in 2010?

MS: We're coming through the worst economic downturn in 70 years, much of it attributable to a bubble in real estate prices. The sector got really hammered, but then so did almost every other asset class. This led to the mother of all liquidity crises for investors, particularly those with high amounts of leverage or exposure to long-term assets, and hence allocation stress. As a result there has been very little new activity in the space, and institutions have been primarily focused on understanding and fixing the problems within their portfolios. Through the latter stages of 2009 and the beginning of 2010, the markets have been recovering, and portfolios have been more stable. The denominator effect has eased, and we've been seeing investors hit the reset button on their overall allocations, and start to return to the market.

The important thing to remember is that real estate is not going away – it's always going to be a core part of most institutional portfolios. However, now that investors have seen how volatile the market can be, they are investing cautiously and also, I think, more wisely. Investors have emerged from the crisis with a better understanding of the constituent parts of their portfolios - they have come up a learning curve – talk about lessons learnt – and now they have a better idea of where they should be investing going forward with a more sober understanding of the risk/reward trade-off.

How will investors be accessing the market in 2010? Will fund structures remain popular, or are we going to see an increase in direct portfolios?

Both funds and direct investments will be important going forward. A direct investment is a very different kind of proposition as investors have to be able to evaluate the asset and undertake the due diligence themselves, rather than simply rely on an experienced manager to do that for them. This usually takes a considerable level of expertise and additional resources to accomplish this successfully. In light of what has happened in the market over the past couple of years, those institutions that have the resources to invest directly – investors that have the appropriate knowledge base, staff and infrastructure – will certainly begin to explore as there are some excellent opportunities out there, but it would be a stretch to suggest that the entire institutional world is moving away towards this model. Most institutions simply don't have the resources to assemble and manage their own portfolios.

As an example, let's assume a pension fund has \$40bn in assets under management, 10% of which is allocated to real estate. In many cases, such a fund might have a small investment staff responsible for this portion of the portfolio, while still subject to the operational bureaucracy often found within a public environment. This would be typical of many institutions, and under such constraints, many significant investors wouldn't have the capability to make direct investments. Co-investments alongside fund managers in which they are invested are also appealing in the current market, but again, the resources needed while not as demanding, still put these outside the capacity of most investment teams.

Where do you think we are in the investment cycle at the moment? For example, we have seen the UK commercial market turning, but is there more bad news ahead for areas of the industry?

The issue here is that real estate always has been and always will be a very local market. It isn't a case of comparing New York to London; it's about comparing one part of London to another a few blocks away! 2009 was a very difficult year, and I don't think there's anybody who isn't aware of all problems that came from residential overleveraging – but the exact same thing happened with commercial mortgages, with still more fallout to come. There is over two trillion dollars' worth of commercial mortgages that needs to be refinanced over the next few years, and there simply isn't enough liquidity in the system to handle that job. There are still further challenges to be faced by the industry, but at the same time we've managed to weather a major shock to the system. While it's clear that the road ahead is not going to be a smooth one, there are also going to be some very attractive real estate opportunities.

What areas are we talking about here – in terms of strategies, geographies etc?

There are some really exciting opportunities for skilful real estate debt investors – for example in the US there are interesting prospects on the residential and land side of the business. There are certainly some major opportunities for those taking advantage of the distress coming through the market but I think that the key factor here is that firms have to be able to not just identify the good investments, but also have the right marriage of operating and investment skills to make them work. Everyone is a distressed investor now – if you aren't one in this market, it simply means that you are overpaying for assets. It all comes down to your skills and

Private Equity Real Estate in 2010: The Road to Recovery?

- Andrew Moylan, Preqin

The private equity real estate market in 2009 was one that was characterised by investor caution, a significant decline in fundraising, poor performance and lack of transaction activity. There were, however, indications towards the end of 2009 that 2010 will be a better year for the industry.

2009 saw a dramatic fall in fundraising, with a total of 96 funds reaching a final close, receiving aggregate commitments of \$40.6bn. This represented just 30% of the \$133bn that was raised by 225 funds in 2008. Fundraising was particularly slow in the third and fourth quarters of 2009, which saw aggregate fundraising figures of \$6.9bn and \$6.8bn respectively. Of all the funds that closed during 2009, 81% raised less than their original target size and 28% closed with less than half their original target. During the course of the year, 69 funds were abandoned or placed on hold, highlighting the difficulty fund managers faced raising capital.

Investor Attitudes

This slow fundraising was a result of a significant shift in investor attitudes. Most investors were inactive in 2009, with many investing far less than they had done in previous years and others not investing at all. In the early part of 2009, many investors were affected by falls in other areas of their portfolios, which left them overallocated to real estate. Others decided to err on the side of caution, delaying investment until they felt the market had stabilised.

There are however, signs that 2010 will see more investor activity. In a Preqin Survey conducted in Q4 2009, 47% of investors questioned said that they were likely to invest in at least one private equity real estate fund in 2010. Of these investors, 58% anticipated that they would invest in the first half of the year. Furthermore, 40% of investors indicated that they plan to increase their allocation to private equity real estate in 2010. Although investors have a clearer picture now than they did a year ago, with more recent real estate valuations and improved stock market performance

meaning they are no longer suffering from the denominator effect, many are still not making definitive plans for the coming year. With a lack of distributions from existing real estate fund commitments, the level of capital available for new investments remains more limited than in previous years.

Fundraising Market

There is certainly no shortage of funds on the road seeking capital and the fundraising market remains extremely competitive. Whilst the number and aggregate target of funds on the road fell over the course of 2009, as of January 2010, there are still 371 real estate funds in market seeking total commitments of \$174bn. This represents significantly more than a year's worth of final closes at the record-breaking 2008 levels. Despite the prospect of improved investor appetite, many firms will still be forced to abandon or delay their fundraising efforts during 2010.

The slow fundraising environment in 2009 has had little effect on the amount of dry powder available to private equity real estate managers, as the lack of deal activity in 2009 meant that call-ups slowed significantly compared to previous years. As of December 2009, fund managers had \$188bn of dry powder available. 2010 is likely to see far more deals being made as fund managers look to invest at the bottom of the market.

Outlook

Fundraising will pick up in 2010, with many investors expecting to be more active in the coming year than they were in 2009. The first quarter or even the first half of 2010 could still see fairly slow fundraising, but the second

half will be stronger. A quick return to the levels the record-breaking years of 2007 and 2008, however, should not be expected. Investors remain cautious and are taking longer to analyse potential commitments. Many have not made concrete plans and may continue to delay new fund commitments. Investors that allocated increasing levels of capital to value added and opportunistic funds in recent years will look to balance these types of commitments with more investments in core real estate. Some commentators have predicted that the private real estate fund model will fall out of favour with investors, but this is simply not realistic. Whilst some of the largest investors may look to have more control over their portfolios through more direct investments or joint ventures, for most, private equity real estate funds offer the best and most efficient way to achieve a portfolio diversified by geography, strategy and property, as well as offering strong returns. Although performance for the most recent vintages of private equity real estate funds has been poor, the asset class has been a very strong performer in the past. Funds that invest during a recession have traditionally been strong performers and investors that have committed to funds of 2008 - 2010 vintages could ultimately receive excellent returns.

owners in need of financing or refinancing for property projects, and look to replace the role of traditional lenders such as banks. Debt funds also look to purchase debt from institutions or operating companies. \$21bn of dry powder was available for real estate debt investments as of December 2009, a small decline on the \$25bn that was available the previous year.

Dry Powder by Region

As of December 2009, there was \$98bn of dry powder available for investment in property projects in North America, \$46bn available for Asia and Rest of World and \$44bn for Europe. North America is traditionally viewed as the leading region in the private equity real estate market and 52% of all dry powder is focused on the region. Dry powder for North American real estate investments has increased substantially in recent years, from \$38bn in December 2003 to \$98bn in December 2009.

Between December 2004 and December 2008 the amount of dry powder available for investment in Asia and Rest of World increased consistently year on year. In recent years there has been an increase in the amount of capital raised by Asia and Rest of World focused private equity real estate funds as investors have looked to take advantage of the boom in Asian property markets and the high returns that have been generated by investments in this area. The amount of dry powder for this region decreased between December 2008 and December 2009, however, as many US and European institutional investors focused their limited resources closer to home in 2009, and Asia and Rest of World focused funds found it difficult to raise fresh capital to replenish dry powder stocks.

Dry powder available for European investments remained relatively consistent between December 2006 and December 2008. There was a significant increase between December 2008 and December 2009, however, resulting in fund managers having \$44bn of dry powder to invest in European real estate as of December 2009.

Fig. 3.3:

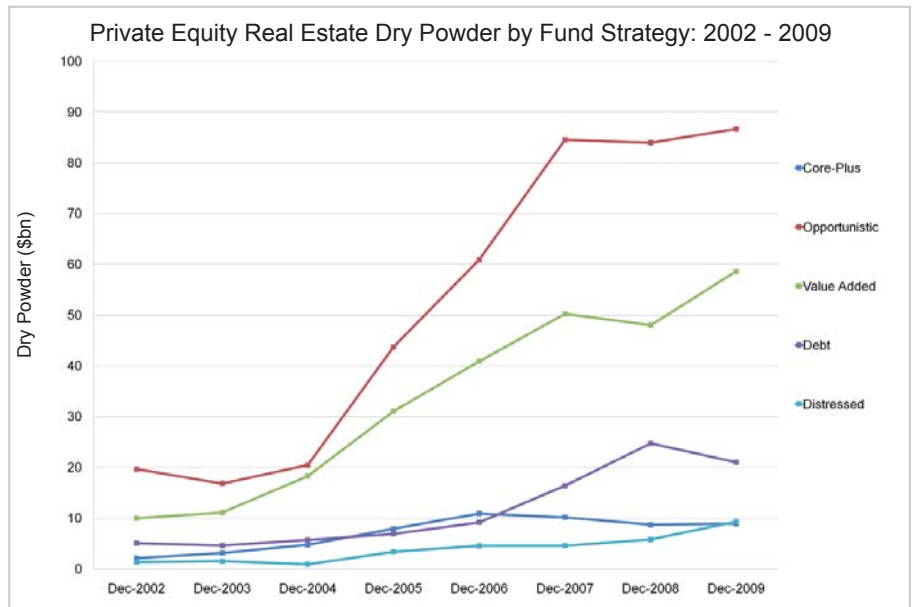
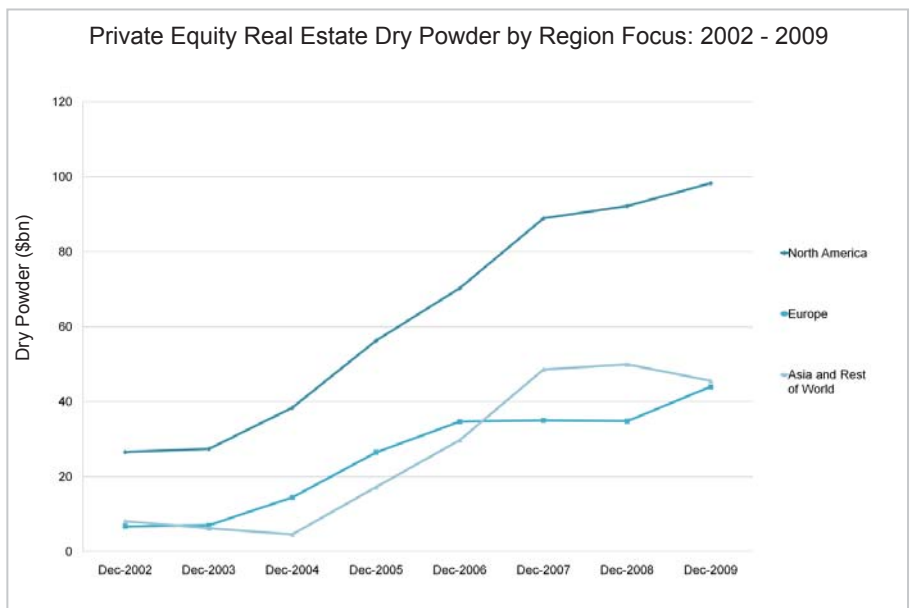


Fig. 3.4:



Overview of 2009 Fundraising Market

2009 saw a significant decline in private equity real estate fundraising, with the aggregate capital raised equating to just 30% of the total raised in 2008. In total, 96 funds reached a final close, receiving aggregate commitments of \$40.6bn. Investor inactivity in 2009 resulted in fund managers delaying final closes, reducing targets and in many cases abandoning fundraising altogether.

breaking year in terms of aggregate capital raised. Fund managers seeking commitments in 2009, however, found fundraising an extremely difficult prospect and the amount of capital raised fell by 70% to \$40.6bn.

Fig. 4.1 shows private equity real estate fundraising since 2003. The industry saw dramatic growth between 2003 and 2007, with the capital raised increasing from \$13bn in 2003 to \$123bn in 2007. 2008 saw fewer funds reach a final close than the previous year, but a number of large funds closed, resulting in a record-

Fundraising by Quarter

Fig. 4.2 illustrates fundraising by quarter in 2008 and 2009. Whilst the first three quarters of 2008 saw strong fundraising, with \$41bn raised in Q3 2008, it has since declined dramatically. The \$16.2bn raised in Q1 2009 represented around half the amount raised in Q1 2008. The third and fourth quarters of 2009 were particularly poor, with just \$6.9bn raised in Q3 and \$6.8bn in Q4.

closed funds in 2009 were in reaching their fundraising goals. 81% of funds that closed during 2009 did so below their original target, highlighting how tough the fundraising environment was. Almost a quarter of funds raised less than half their original target and only 10% of funds exceeded their target. In contrast, the 2007 market was extremely buoyant, with 79% of funds meeting or exceeding their fundraising targets and 26% of funds closing with more than 120% of the capital originally targeted.

Regional Focus

Fig. 4.4 shows how the private equity real estate fund market is split by regional focus. Funds with a primary focus on North America raised \$21.4bn in 2009, equating to 52% of the total capital raised worldwide. 25 funds primarily focused on Europe raised a total of \$13bn, whilst 21 funds focused on Asia and Rest of World reached a final close having received aggregate equity commitments of \$6.2bn. Although fundraising fell across the entire market in 2009, the fall was particularly notable for Asia and Rest of World funds, which accounted for 15% of the aggregate total in 2009, compared with 27% in 2008. It is important to note, however, that many of the largest funds with a primary focus on North America also make investments on a global basis.

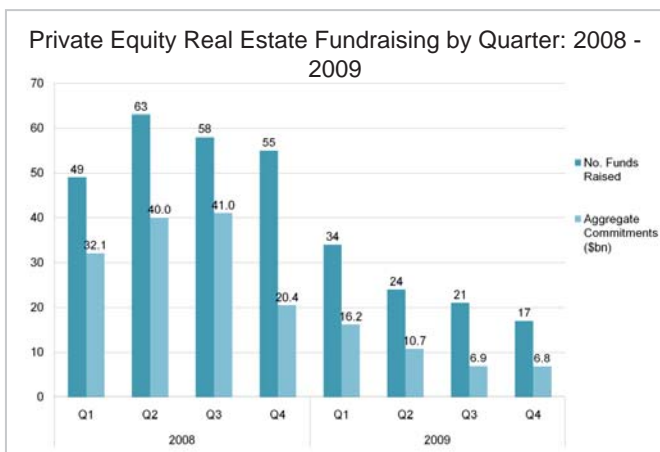
Success in Achieving Fundraising Target

The proportions of fund managers that meet, exceed or fall below their respective fundraising targets is a good indicator of investor appetite for private equity real estate. Fig. 4.3 shows how successful firms that

Fig. 4.1:



Figs. 4.2 & 4.3:



Overview of Real Estate Fund Managers

The number of active private equity real estate fund managers has increased significantly over recent years, as new firms were established in order to take advantage of investor enthusiasm for the asset class and more established firms looked to raise private equity real estate funds for the first time. Despite the troublesome fundraising environment at present, there are still new players entering the industry, feeling that they have the ability to generate strong returns in the current market. Preqin has identified 967 active private equity real estate firms, managing over 2,500 funds.

Fund Manager by Location

Fig. 6.1 shows the global distribution of private equity real estate firms by region. 534 managers are based in North America, accounting for 55% of all firms globally. 282 firms are based in Europe, whilst 151 firms are based in Asia and Rest of the World, corresponding to 29% and 16% of the overall total respectively.

Fig. 6.2 shows the countries with the greatest number of private equity real estate firms. The US is the country where the largest numbers of firms are based, with 521 representing 54% of all private equity real estate firms globally. The UK is the next most significant country with 126 firms, accounting for 13% of the global total. The third most prominent country

is Australia, which has 25 firms. India Germany and the United Arab Emirates are other notable locations of private equity real estate, with 23, 22 and 21 fund managers respectively.

Fig. 6.3 shows the top 10 cities for private equity real estate firms. US cities dominate the list with six of the top 10 located there, whilst London represents the sole European city in the top 10. New York is the most popular city where 114 firms are headquartered. Sydney, Dubai and Mumbai are notable examples of non-European and non-US cities, which are popular locations for private equity real estate firms, with 18, 16 and 15 fund managers respectively.

Fig. 6.4 shows the top 20 real estate firms by aggregate capital raised. Blackstone Real Estate Advisors leads the way having raised over \$27bn in investor commitments. Lone Star Funds and Morgan Stanley Real Estate are other notable examples of large real estate fund managers, with both raising over \$20bn in investor commitments. ING Real Estate Investment Management is the highest non-US firm in the top 20. The Netherlands-headquartered firm manages a wide range of funds preferring to raise country or region-specific funds rather than the 'mega' funds raised

by many of the largest managers. As a result ING has managed more than 30 private equity real estate funds, and currently has five funds in market.

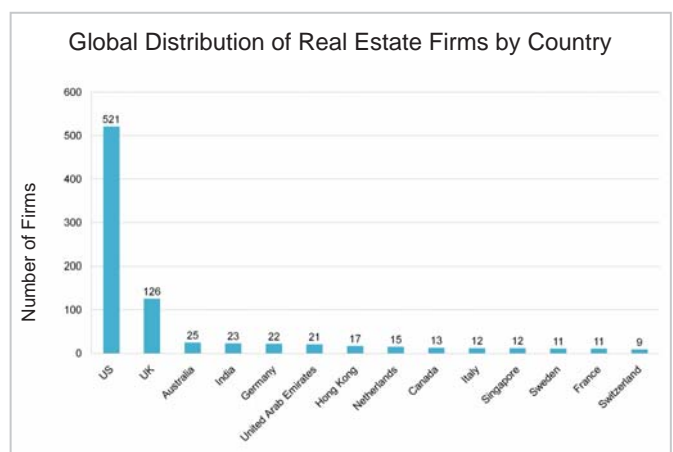
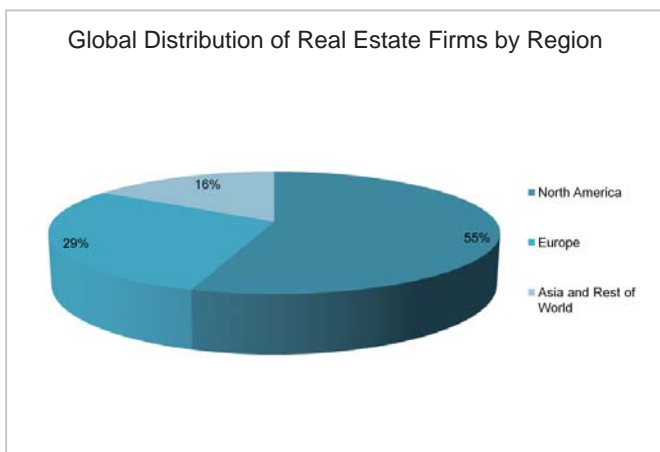
Fig. 6.5 shows the largest private equity real estate funds of all time. Blackstone Real Estate Partners VI is the largest fund ever closing, in Q1 2008 with commitments of \$10.9bn. The fund uses an opportunistic strategy of acquiring institutional assets located in the US. The largest fund to close in 2009 was the Blackstone Real Estate Partners Europe III, which gained commitments of €3.1bn.

Fig. 6.3:

Top 10 Cities for Private Equity Real Estate Firms (Headquarters)

City	Number of Firms
New York	114
London	101
Chicago	33
Boston	27
Los Angeles	24
San Francisco	22
Dallas	18
Sydney	18
Mumbai	16
Dubai	15

Figs. 6.1 & 6.2:



Private Equity Real Estate Firm Investment Criteria

Private equity real estate firms make, on average, 11 to 16 transactions a year. The acquisition criteria, strategies applied to add value and holding period for assets vary significantly between different firms. This section analyses the acquisition criteria of private equity real estate firms globally.

Applied Strategies

Fig. 7.1 shows the strategies used by opportunistic fund managers to add value to their investments. As might be expected for firms targeting the highest returns from their investments, three-quarters of firms that manage opportunistic vehicles incorporate real estate development as part of their investment strategy. 48% of fund managers aim to reposition assets they have acquired and 44% of firms redevelop properties. Other commonly employed strategies are renovation, rehabilitation and re-tenanting, employed by 25%, 22% and 20% of firms respectively. 18% of fund managers will consider purchasing portfolios of real estate assets. The same percentage of fund managers will invest in real estate operating companies. Typically, this is a strategy followed by larger fund managers, as this type of investment requires greater resources.

The strategies utilised by value added fund managers are shown in Fig. 7.2. Whilst development is still the most commonly used strategy, with 59% of

firms applying this strategy, a smaller percentage of value added firms are involved in real estate development projects than opportunistic fund managers. Redevelopment and repositioning, strategies that are most commonly associated with value added fund managers, are each employed by 49% of such firms. Renovation and leasing strategies are stated as preferences by 36% and 29% of firms respectively.

Property Types

The property types being targeted by real estate fund managers with a fund currently raising, are shown in Figs. 7.3, 7.4 and 7.5. There are distinctly different trends in the most commonly targeted property types in each of the three regions. For US focused funds, it is office assets that are most frequently targeted by fund managers: 44% of funds with a primary focus on the US are targeting office investments, while 33% of funds will invest in industrial assets, and 32% in multi-family properties. A quarter of funds are targeting retail properties, with

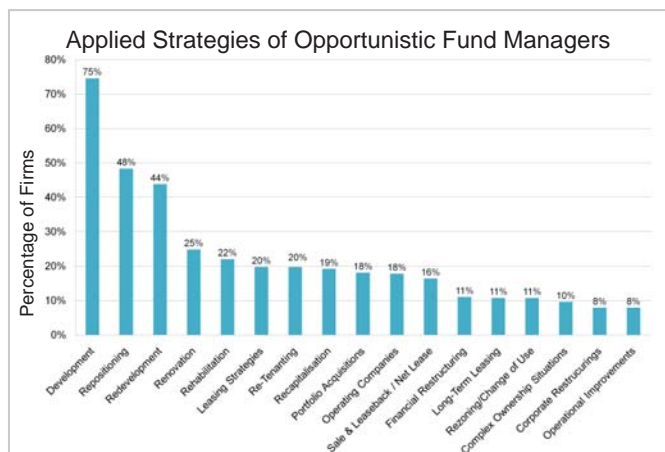
the same percentage looking to invest in general residential assets.

For Europe focused funds, it is retail properties that are most commonly targeted, with 37% of funds in market looking to invest in retail assets. 31% of funds are targeting office properties, 29% residential, 25% any commercial properties and 25% industrial. For Asia and Rest of World funds a different trend emerges. 62% of funds focused outside North America and Europe are targeting residential assets. Retail is the next most commonly targeted property type, with 42% of funds targeting this sector. 38% of funds are looking to invest in office properties, 36% commercial property, 22% hotels and 20% industrial.

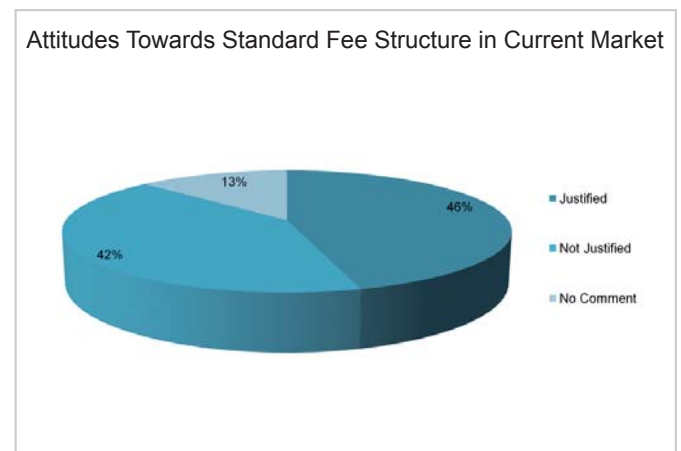
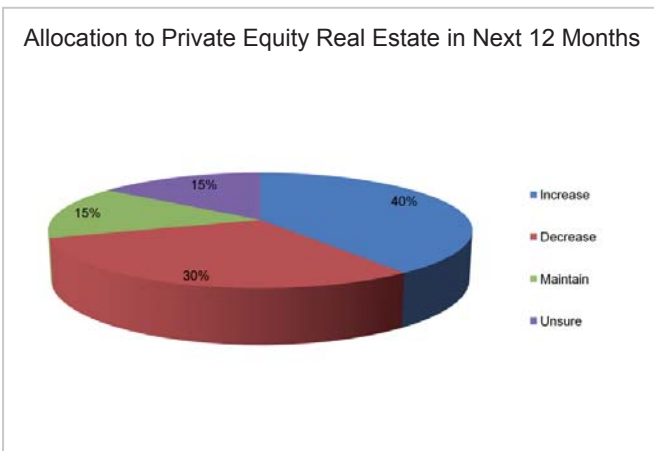
Transaction Size

The average transaction size targeted by private equity real estate firms also varies significantly by region. European firms target, on average, transactions between €21mn and €213mn. This is larger than the average US-based firm, which targets between \$13mn and \$188mn. This may

Figs. 7.1 & 7.2:



Figs. 9.10 & 9.11:



of investors hoping to stabilise and limit the risk in their portfolios. Leverage utilised by the higher-risk strategies was another concern for investors, and this may be one reason why they are targeting core and core-plus funds that utilise little or no leverage.

Whilst interest in the more prevalent opportunistic and value added funds remained relatively stable compared to previous years, investors are also becoming increasingly interested in the growing debt and distressed markets and many said that they wanted to purchase fund stakes on the secondary market. A few investors, such as a UK public pension fund, said they will consider investing in funds from around the world and are open to all fund strategies. Whilst others, such as a US asset manager and a German insurance company, have stated that they will focus on their own continents.

Private Equity Real Estate Allocations in Next 12 Months

When asked about their allocations to private equity real estate in the next 12 months, 40% of investors believed that it would increase whilst 30% expected it to decrease. 15% said they would be maintaining their allocation and the remaining 15% were unsure. The 40% intending to increase their allocation to private equity real estate suggests that many are hoping to take advantage of lower property prices and the opportunities created by the recession. Therefore, 2010 may see an improvement in fundraising compared to 2009.

The 30% looking to decrease their allocation is consistent with the significant proportion not looking to invest in private equity real estate in 2010, avoiding these investments for a longer period of time.

Attitudes towards Standard Fee Structure

When asked whether the typical management fee of 1.5% and the typical carry of 20% charged by private equity real estate fund managers were still justified in light of market conditions and the difficult investment climate, 46% felt that it was, while 42% of investors were not happy with the fee structure, believing that fees were too high and should be lowered. Many investors expressed concerns over fees and felt that they should be lower regardless of market conditions. Some institutions claimed that they were in the process of renegotiating the fees they were paying for existing fund investments, whilst another investor claimed that it was only the larger investors in the funds that could negotiate and reduce their fees, and it was harder for those making smaller commitments. Another investor believed that certain fund managers justified the fees they were charging due to good performance, whilst others did not.

Conclusion

The survey results show that investors remain interested in the private equity real estate industry and that many plan to be active in the market this year. However, many are still unsure or are actively not willing to commit to the industry in 2010 and are remaining cautious. Those that will commit are uncertain of the amount of

capital they will commit and the number of commitments they will make. The timing of the next commitment is also undecided for many institutions. This lack of structure is uncharacteristic for an industry that has been relatively formulated in recent years. Those investing are less likely than they were in the past to invest beyond familiar regions, and lower-risk fund investments, as well as debt and distressed funds, have grown in popularity.

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