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CAPITAL MANAGEMENT, LLC

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BEING THE EARLY BIRD: RE-FOCUSING EMERGING MANAGER PROGRAMS ON DEBUT FUNDS AND FIRST CLOSES

September 2010

Being the Early Bird:
Re-Focusing Emerging Manager Programs on Debut Funds and First Closes

During a recent real estate emerging manager event, a common frustration permeated discussions among fund managers in attendance. If there appears to be widespread conceptual support for emerging manager real estate programs, why are so few emerging managers enjoying fundraising success? Is it the real estate market? The caliber of the emerging managers? Are there too many definitions of "emerging manager" being applied too inconsistently?[1] Emerging manager-focused conferences are successfully attracting large crowds and big sponsorship dollars, leading one to believe there is an endless supply of money available in the space. Yet, this support is not matched through actual commitments to emerging manager funds. We believe there are a number of factors potentially impeding investments in emerging managers, but the biggest hurdle is overcoming the myths surrounding emerging real estate managers. While conceptually many investors appear to support emerging real estate managers, we believe that in reality, many investors are hiding behind these myths and not willing to commit to true emerging managers.

Myth #1: The Economy Is To Blame

For both established and emerging real estate managers, the view that real estate caused the downturn and destroyed everyone's portfolio (not to mention the global financial system) is not easy to overcome. There are a number of investors plagued by portfolio issues, and for them, the economy and liquidity issues may be a valid excuse to remain on the sidelines. For investors excited about emerging real estate managers, however, this argument is not quite as compelling. Quite the contrary, the market dislocation, limited leverage and overall crash in real estate prices create the perfect opportunity for emerging managers.

Suddenly, the golden handcuffs binding talented investment professionals to their current funds have lost their luster. The lure of any near-term (and possibly long-term) carry has probably disappeared. In many instances, the fund or parent institution may be in shambles, if it even still exists. Just as numerous "established" real estate icons such as Barry Sternlicht (Starwood Capital), Tom Barrack (Colony Capital), John Grayken (Lone Star) and others "emerged" during the RTC era, we would like to think that this current environment will sow the seeds for the next decade of innovative real estate investors. Just to name a few, the Bears, Lehmans, Merrills, MSREFs and GEs of the world trained a lot of talented individuals who are now "financially liberated" and able to embrace a new entrepreneurial opportunity. And there are countless other smaller funds which, for a variety of reasons, are also experiencing an outflow of talented professionals, contributing to the volume of real estate emerging manager talent in market.

If the history of the RTC-era is any guide, the best of these new real estate managers are going to generate attractive returns for their investors and enjoy careers spanning multiple decades.

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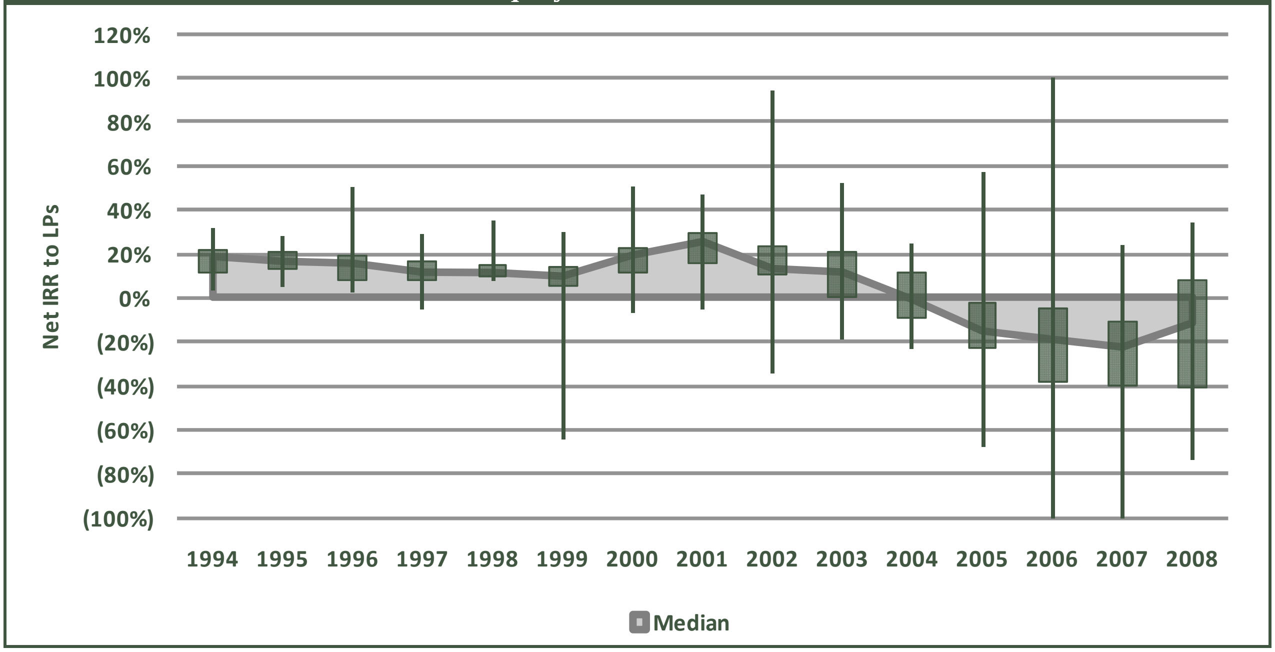
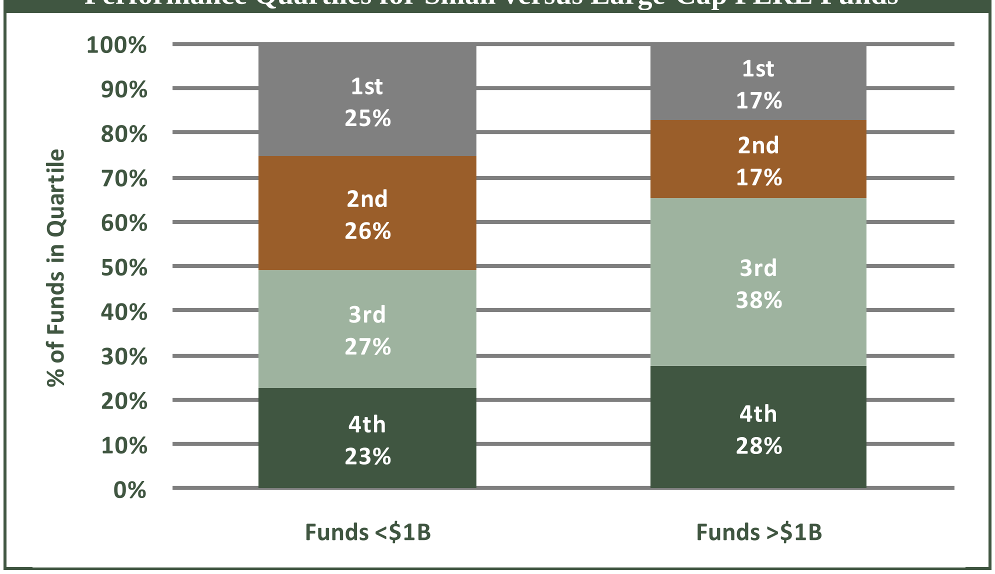
[1] Before going any further and adding to the confusion, we should note that this paper uses the term "emerging manager" to mean a 1st, 2nd or 3rd institutional fund targeting a capital raise of $1 billion or less, and with less than $2 billion of aggregate AUM; minority and women-owned firms ("MWBEs") are a subset of emerging managers.

Historic Private Equity Real Estate Return Distributions[2]



We believe this generation's "RTC" is capable of producing comparable results. Not only are real estate managers able to benefit from the information available through the internet and lessons of the "lost decade," but also from added perspectives of a more diverse real estate universe. Interestingly, since the RTC-era, smaller funds have also generated stronger returns than their larger counter-parts. Based on performance tracked by Preqin, over 50% of U.S. funds under $1 billion in size have been able to achieve 1st and 2nd quartile performance, relative to only 34% of funds larger than $1 billion.

Performance Quartiles for Small versus Large-Cap PERE Funds[3]



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[2] Based on Cambridge Associates Real Estate Funds benchmark as of 03/31/10.
[3] Based on Preqin database as of August 1, 2010.

Myth #2- There Aren't Enough Quality Emerging Real Estate Managers

Just how sizable is the emerging real estate manager universe? How about the MWBE-sponsored real estate funds? Preqin data as of August 2010 lists 109 sponsors in the market raising repeat funds. Similarly, the Prequin database contains 96 sponsors in the market raising first-time funds. Over the past 18 months alone, we have received materials from over 200 emerging manager real estate funds, many of which are "spin-outs" from prior real estate firms. We also estimate that the number of women and minority-owned funds has more than doubled since 2008.

While the economic dislocation and unlocking of the golden handcuffs is undoubtedly adding to these numbers, the impact that social and educational efforts targeting women and minorities has had should not be underestimated. For example, the Toigo Foundation was founded in 1989 and launched its first class of MBA fellowship recipients in 1990, with seven students. Today, the alumni MBA network of the Toigo Foundation is over 800 alumni strong and averages more than 50 Toigo Fellowship recipients per year.[4] We believe that the combination of underwater economics and successful social and educational programs has created the perfect environment to foster the growth and success of the emerging manager real estate universe.

But are these emerging managers investment-worthy and capable of generating attractive returns? Certainly, many emerging real estate managers in the market may not be cut-out for institutional investors. Fundraising is a learning process for these managers, and now more than ever it tests the resolve of an emerging manager. Numerous small managers have had great success targeting small investors for one-off deals, and some of them will learn they are better-suited for non-institutional investors. For those that stay the course and have the patience and desire to pursue institutional investors, chances are this process will help create a strong firm culture and strategy. Historically, we've witnessed many emerging managers who endured a time-consuming due diligence process produce very attractive returns for their investors. Weak team dynamics, conflicting investment philosophies and processes and poorly-conceived strategies are typically exposed during prolonged fundraising periods, lending credence to the adage "what doesn't kill you makes you stronger."

With over 200 U.S.-based emerging real estate managers fundraising[5], it is a large universe of funds to sift through. It may not be easy to find the top-quality emerging managers; not all come wrapped with a bow carefully tied by a placement agent, or even an internal investor relations professional. The process of meeting with an emerging manager, undertaking extensive due diligence and sometimes holding its hand often takes a lot of work. That said, we have found the sophistication and transparency of many emerging managers to be a refreshing surprise. Many investment professionals spinning out from established shops seem to have learned important lessons from their prior experience and welcome the opportunity to outshine their established counterparts through an extremely investor-friendly, ILPA principle-embracing posture.

So yes, a lot of frogs have to be kissed before finding a prince among emerging real estate managers. But isn't this true of established managers as well? Granted, the check sizes vary and kissing endless frogs for a $10 million commitment is a time-consuming process, but to find this generation's super-star, it's a worthy endeavor.

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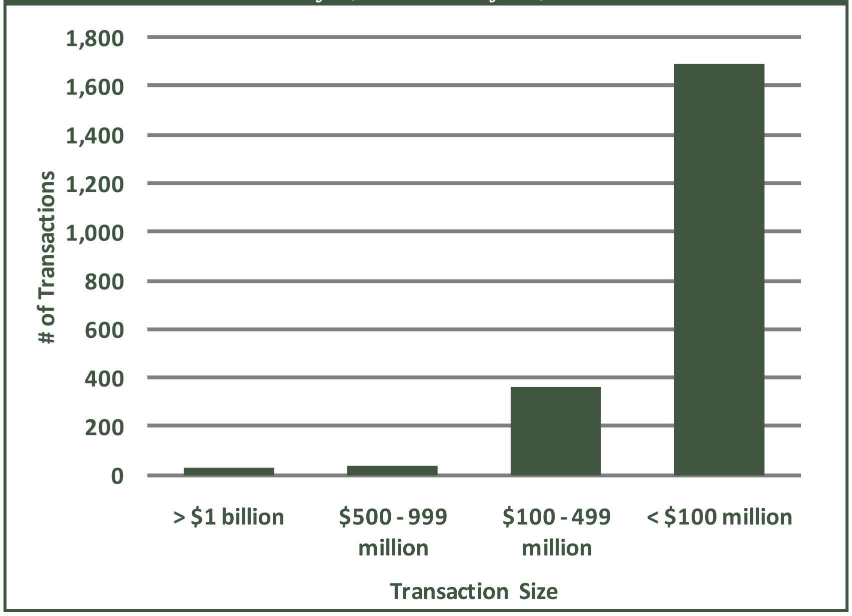
[4] The Robert Toigo Foundation website, www.toigofoundation.org.
[5] Based on Morgan Creek estimates as of August 25, 2010.

Myth #3- Emerging Managers Can't Source and Close on Attractive Deals, or Get Debt Financing in the Current Environment

Although the debt markets are improving, it can still be difficult to obtain debt for all but core stabilized assets. Certainly, while some mega-firms may be able to easily secure financing, an emerging manager is going to have an uphill battle sourcing financing. Even in good times, however, emerging real estate managers encountered challenges obtaining financing. We believe these historic lending hurdles can work to the advantage of emerging real estate managers, particularly in today's less liquid environment. Emerging managers are accustomed to having challenges finding debt and raising capital. They are not strangers to one-off deals or having to build a track record using their own capital.

Real Estate Transactions by Size
January 1, 2008 - July 28, 2010[6]



Emerging real estate managers also have a crucial advantage sourcing deals in the current market. Their unique relationships focus on under-served geographies and willingness to target "ugly" deals in non-core markets all provide a tremendous source of potential alpha for their strategies. While we read newspaper headlines about GGP, Extended Stay and one enormous FDIC portfolio after another being heavily bid upon, few read or care about the small manager that acquires a multi-family property in San Antonio. Despite the headlines, there are a tremendous number of investment opportunities in the market for smaller managers. Globally, since 2008, there have been almost 1700 deals of less than $100 million, and only 62 deals with price tags greater than $500 million. In the U.S., there have been over 660 deals of less than $100 million and only 15 deals in excess of $500 million.[7]

Further, emerging real estate managers expect to add value to the property in order to generate returns; relying on leverage and cap rate compression has not typically been a cornerstone of their strategy.

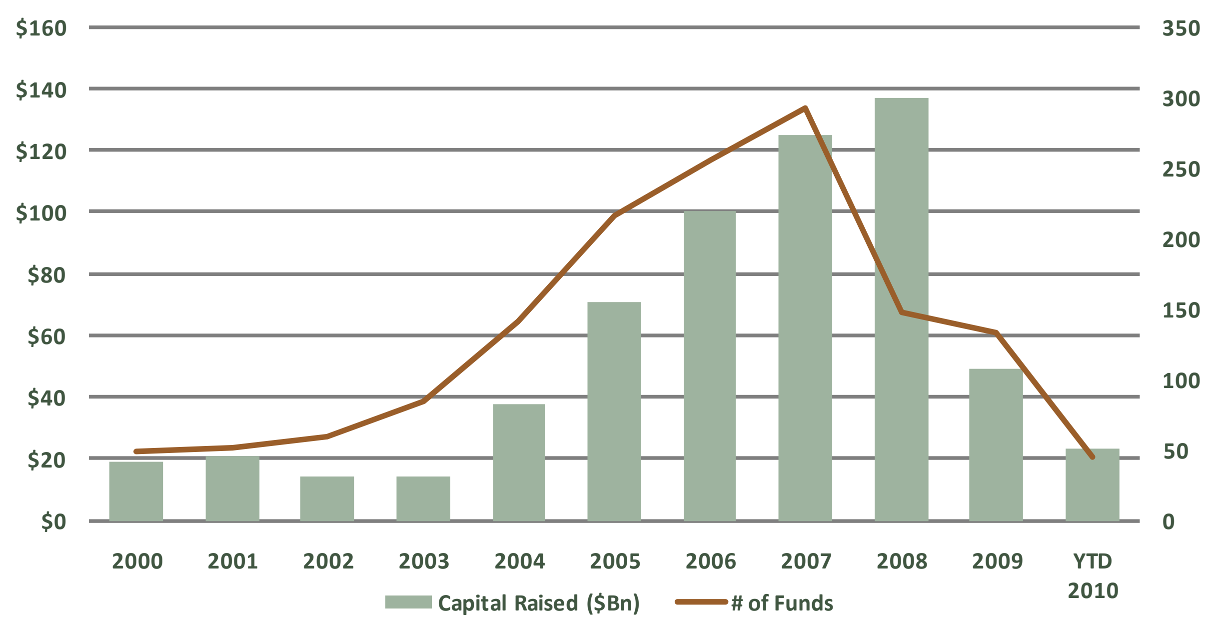
[6] Atlantic-Pacific Data, July 28, 2010. Includes all deals in which the aggregate transaction size was disclosed.
[7] Atlantic-Pacific Data, July 28, 2010. Includes all deals in which the aggregate transaction size was disclosed.

Finally, for every dollar the emerging manager is unable to raise, his/her own capital is being invested. Instead of 90% financing, the emerging real estate manager has likely leveraged aspects of his/her personal life, and those of friends and family, to find the money for this high conviction transaction. If the deal fails and loses money, the emerging manager will feel the repercussions of that failure in a much deeper way than an established manager. To say the emerging real estate manager's interests are aligned and he/she is motivated to succeed is an understatement.

Myth #4- Emerging Managers Aren't Having Closings Rendering It Impossible To Invest

Without a doubt, the fundraising environment is difficult. Very few managers are fortunate enough to have closings, whether established or emerging. Based on Preqin data, global real estate fundraising continues at a decade-low pace, with a small number of funds raising a disproportionate amount of the capital.

Historic Global Private Equity Real Estate Fundraising[8]



The U.S. fundraising market further highlights the slowdown in fundraising, especially for emerging managers. Based on Preqin's July 2010 data, since 2008, 164 U.S. sponsors have closed on successor funds with $98 billion of capital raised whereas only 48 first-time U.S. funds had closings on $11 billion.

Why is there such a large discrepancy? Why do emerging real estate managers, and in particular first-time funds, suffer from a constant Groundhog Day of "good meetings" that never result in capital and usually don't even result in PPM requests. While everyone is attending conferences and talking about emerging managers, there seems to be a disconnect between investor's enthusiasm for emerging managers and their willingness to commit. The concept of emerging managers sounds compelling, until the challenges of implementation and the reality of the necessary time commitment set in. Investors aren't able to do the work, hold the hands, anchor the first close,

[8] Preqin database, as of August 1, 2010.

help with introductions and dedicate the time and resources that the emerging real estate managers may require. It is much easier to wait and ride on someone else's coat-tails. Talk to me "after your first close." Or "come back once you have some investments." These commonly heard mantras do a tremendous injustice to emerging managers and emerging manager real estate programs. These unfortunate statements are typically followed by "well, you just don't seem to be getting traction in the market" or "you don't seem to have investments or deal flow." And so the emerging manager revisits the classic catch-22 of needing capital to be able to raise capital.

Investors need to recognize that supporting emerging managers means being there on day one. Emerging manager programs are intended to create, and emerging real estate managers desperately need, a class of investors willing to stand up and say "I do." To be willing to take a stand and make a commitment when no one else will; to be willing to put in the time to assist the manager with documents, fundraising and processes; to be the flag around which other investors, those waiting for subsequent closings, can rally. If emerging manager programs do not include an emphasis on debut funds and first closings, the myths of insufficient managers and no closings increasingly becomes a reality. The vicious cycle will be perpetuated and we will be deprived of many rising young stars and the next generation's top performers as everyone waits for the first close to happen….with someone else's time and money.

Being first is not easy, and it should come with some perks. Hopefully, in addition to the unique deal-flow and motivated managers, true first investors in debut institutional funds will be rewarded both economically and through their relationship with the emerging manager. Preferred terms through reduced management fees, increased preferred returns and decreased carried interest are often the boon provided to an investor willing to be first in line. Hopefully the intangible benefits are even more compelling. Any emerging manager worthy of investment should recognize the importance of this first anchor investor and reward the investor handsomely through favorable co-investments, preferential allocations once they "make it big" and generally fostering a strong, long-lasting relationship.

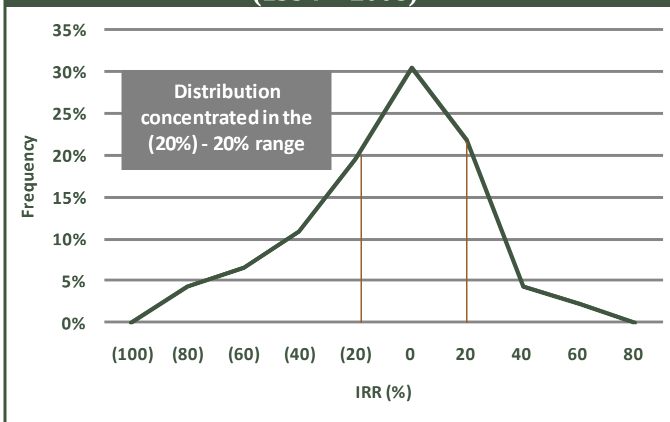
Myth #5- Debut Funds and First Closes Are Too Risky

Emerging manager investing is risky. But so is real estate investing generally. The "Certain Risk Factors" section of any real estate PPM contains a litany of reasons to be concerned about real estate investing; risks that are virtually identical for emerging managers and established managers. Perhaps the emerging managers would garner an additional "The Team Has Not Previously Worked Together" and maybe even a "The Fund Has No Prior Track Record." Arguably, these are just different ways of saying "Past Performance Is Not An Indicator of Future Returns," and "At Any Given Moment, the Team Members May Wake Up and Hate Each Other," which are certainly risks of all managers.

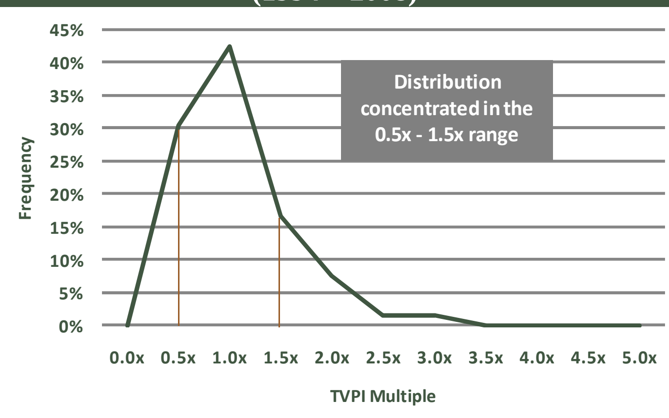
Of course, there is an element of the unknown with emerging managers. The team dynamic, day-to-day roles, processes, operational naïveté, quirky habits, insecurities, relationships and expectations are all potential issues somewhat unique to emerging managers; and, of course, there are economic issues. Salaries, bonuses and carry splits can become divisive issues. The sale of an interest in the general partner, which is potentially accretive in fundraising, can lead to significant misalignment between limited partners and general partners and cause added friction and headaches for the investment team over time. And then, there is the strain caused by a prolonged fundraising process with no current income. These are all legitimate issues that require a lot of time and discussion. Can any one of these problems cause an emerging manager to blow-up? Yes. But can many of these problems and others also surface and have a significant impact on an established manager? Absolutely.

In the current market, we would even argue that emerging managers may enjoy some significant advantages over established managers. First, actually surviving a brutal fundraising process and enduring the personal sacrifices that accompany a start-up business should create a resilient team dynamic. In addition, emerging managers have a clean slate, and if successful in raising money, are able to take full advantage of the current market dislocation without being weighed down by troubled investments. Meanwhile, many established managers are struggling with legacy issues, pointing fingers at each other, and having to re-cast acquisitions experts as work-out professionals to help eke out a return of capital for investors all while grappling with potentially significant team departures. The numerical data supports this argument. Both emerging and established managers have relatively similar returns volatility, but from both an IRR and multiple perspective, smaller funds are centered around a higher average return.

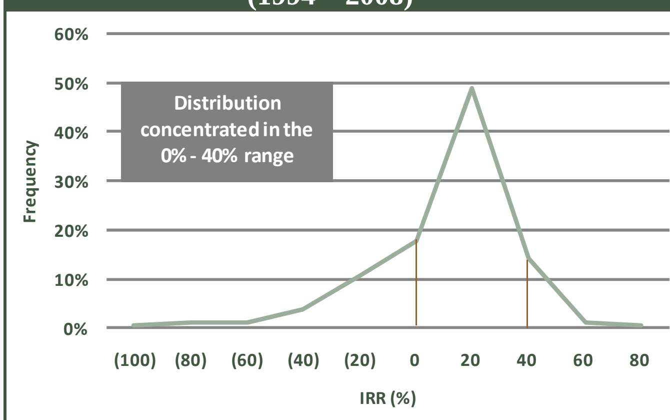
Large Fund (≥$1 billion) IRR Distribution (1994 – 2008)[9]



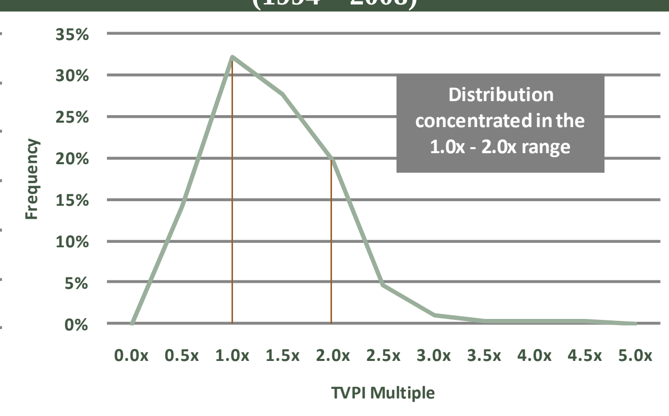
Large Fund (≥$1 billion) Multiple Distribution (1994 – 2008)[10]



Small Fund (<$1 billion) IRR Distribution (1994 – 2008)[11]



Small Fund (<$1 billion) Multiple Distribution (1994 – 2008)[12]



[9] Based on Preqin database, as of August, 2010.
[10] Based on Preqin database, as of August 1, 2010.
[11] Based on Preqin database, as of August 1, 2010.
[12] Based on Preqin database, as of August 1, 2010.

So why, if emerging real estate managers are generally able to achieve attractive returns with relatively similar risk as established managers, is the industry so reluctant to invest? Maybe we are really projecting our own fears about risk onto emerging managers. We all get it wrong sometimes. But you don't usually hear "What were you thinking, investing in Lehman?" Alternatively, one can readily imagine a scenario where you are forced to endure ridicule (and worse) for a failed investment in "Small Unknown Fund 1."

In fairness, not everyone is incentivized to take this personal risk. Many real estate investment professionals receive the same compensation regardless of performance; they neither reap the financial benefits of the upside nor suffer the consequences of the downside- at least not financially. Reputationally, a bad decision on a "risky emerging manager" could mean a new job search. Realistically, this means that emerging managers are not appropriate investments for everyone, particularly as direct investments. But hopefully, there are also investment professionals out there who are rewarded for this risk- investors who are compensated based on performance and incentivized to seek out the additional alpha that we have seen emerging managers offer. Because all this leads us back to our over-arching concern, if no one is willing to do the work and take the time, how will the super-stars of the next generation be discovered?

We have found tremendous benefit in our emerging manager relationships in real estate and across other asset classes. Although being there first can be difficult – and sometimes in the throes of frustration about legal documents, processes or other issues, we question whether the energy invested is worth it – we firmly believe it is. We have a strong conviction that as an emerging manager investor, it is our obligation to support quality debut funds and invest the time and effort to help them hold a first close. And we certainly hope that as some of our recent emerging manager investments translate into attractive returns (especially with the help of preferred terms), that our clients are able to enjoy the success of these debut funds and the strong franchises they build for years to come. Sure, free-riders with less economic motivation may follow, but as Abraham Lincoln once noted, "Things may come to those who wait, but only the things left by those who hustle."

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The Internal Rate of Return is the discount rate at which the present value of the future cash flows of an investment equal the cost of the investment. It is found by a process of trial and error; when the net present values of cash outflows (the cost of the investment) and cash inflows (returns on the investment) equal zero, the rate of discount being used is the IRR. When IRR is greater than the required return-called the hurdle rate in capital budgeting-the investment is acceptable. *Definition from Barron's Financial Guides, Dictionary of Finance and Investment Terms.*

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