A Historic Opportunity In Distressed Real Estate

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Commercial real estate ("CRE") remains an intensely cyclical business. We have always believed that the greatest arbitrage opportunity is not, as is commonly believed, the difference in price between asset A and asset B. Rather, it is the difference between the price of asset A at the bottom of the market and the price of asset A at the top of the market.

EXECUTIVE SUMMARY

Broad-based measures of commercial property prices in the U.S. declined over 40% during 2008 and 2009 taking most real estate investment management firms by surprise.[1] Today, the slow process of clearing the market of the wreckage left over from the overvaluation and overleveraging that was rampant during the pre-2008 credit boom continues. There remains a persistent overhang of unresolved commercial mortgage maturities and fractured ownership structures in the U.S. measuring in the trillions of dollars. Many of these real estate loans remain under water and will require additional capital infusions to resolve. Yet the vast majority of the debt and equity capital that has been raised in the last four years has been tightly focused on "core" assets, where prices have rebounded to near peak levels. Very little capital is focused on "core" quality assets in non-core situations, i.e. those suffering from financial distress. The valuation spread between these two categories is large.

We believe that the value being left on the table today represents an extraordinary and timely opportunity for an investor with the ability to see today's real estate investment landscape clearly to acquire interests in good quality commercial property at deep discounts and to earn opportunistic returns.

Very little capital is focused on "core" quality assets in non-core situations.

1 Moody's/RCA Commercial Property Price Index (CPPI) – Core Commercial Composite Index. Data as of October 2012.

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* BNY Mellon owns a 20% interest in Siguler Guff & Company, LP and certain related entities (including Siguler Guff Advisers LLC).

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Why should there be an opportunity to purchase good quality CRE at deep discounts and earn "opportunistic" type returns?

The real estate investment industry has traditionally been more focused on vintage diversification, alpha generation and passive, top-down, property-type and geographic portfolio construction and diversification techniques. We reject an overreliance on these methodologies as being indicative of a lack of conviction in timing, strategy and in the valuation merits of individual transactions.

Our particular view of the CRE world and the nature of the opportunity set within it therefore leads one towards an investment strategy that relies heavily upon the ability to examine holistically the entire universe of real estate assets, loans, securities and geographies in the search for value. It requires high conviction, strict investment discipline (particularly sell discipline, and partners/managers that exhibit the same), open architecture in structuring, an intense focus on alignment of interests with and good governance of these managers, and the ability to deploy capital in scale and with alacrity into niche opportunities in order to command the best possible financial terms.

TIMING IS EVERYTHING

It has now been over four years since "The Point of Maximum Uncertainty", March 9, 2009, when the S&P 500 Index closed at 676.53. Do you remember how it felt? All of us in the investment industry do. That is precisely why there is an opportunity in CRE today. The institutional memory of an unexpected and precipitous 40% drop across the board in commercial property prices in the U.S. during the 2008-2009 time period has scarred investors' psyches. The fear of that traumatic experience lingers and still animates investors' decision making today. Their risk aversion is palpable in the marketplace. We believe that the value being left on the table is an extraordinary opportunity for an investor with the ability to see through the turmoil in today's real estate market.

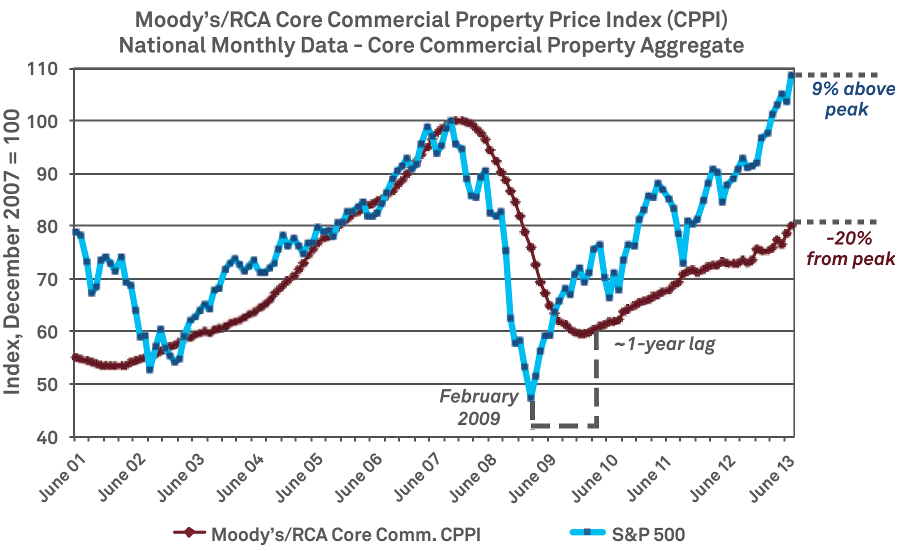
In early 2007, the peak of the last cycle for CRE pricing, most investors were motivated by a very different type of fear – the fear of *not* making the types of heady returns that they witnessed many other investors making – the fear of being left behind. They *sought out* risk. They had a much higher propensity to opt for "opportunistic" business models. They agreed to real estate investment programs that included ground-up development, often with substantial components of for-sale housing, and they tolerated high levels of leverage, all when valuations were clearly high.

The psychology of investors, which is forever tracing out cycles of fear and greed, continually conspires to make market highs higher and market lows lower. What else could explain this irrational impulse to seek risk when valuations are high and when there is more capital in the marketplace than there are opportunities, and to become highly risk averse ("cautious" in investor conference parlance) when valuations are low and when there are more opportunities in the marketplace than there is capital?

As of this writing, the S&P 500 Index is hovering around the 1,600 range, very close to its 2007 peak. The liquid markets – equities, fixed income and REITS – have all rebounded quite significantly and stand close to or beyond previous peaks. So what is different about CRE? Why should there be an opportunity to purchase good quality CRE at deep discounts and earn "opportunistic" type returns?

First of all, illiquid markets clear slowly. They operate with a large time lag compared with liquid markets. Stocks bottomed on March 9, 2009, but the CRE pricing trough wasn't directly observable until over one year later, when the March 31, 2010 tick on the Moody's Index, as shown in Figure 1 below, was published in April of 2010.

Figure 1: The CRE Recovery Lags: Liquid vs. Illiquid Markets



Source: Moody's/RCA Commercial Property Price Index (CPPI) and Bloomberg, July 2013.

How is it that the bottom tick in CRE pricing takes so long to manifest itself?

The last long down cycle in CRE began essentially with the recession in the third quarter of 1990. The stock market, as measured by the S&P 500 Index, bottomed at around 300 on September 28, 1990, almost precisely to the day when the recession ended, in late September of that year. With regard to CRE, however, we know with the benefit of hindsight that the best subsequent five-year cumulative returns for CRE coming out of that period was the 1996 *vintage year, over five years after the recession.*[2] By January of 1996, in contrast, the S&P 500 Index had already doubled from its bottom. The opportunity in CRE manifested itself most profitably years after the liquid markets had fully recovered.

How is it that the bottom tick in CRE pricing takes so long to manifest itself? Price discovery alone in CRE takes 9-12 months, given the rearward-looking appraisal-based valuation methodology. Each share of IBM common stock is the same as every other share. CRE assets, on the other hand, are very far from being homogenous. The information required to price heterogeneous assets takes a long time to percolate back into the market after a severe price move. As a result, market participants are slow to trade before new pricing data becomes available and this lack of trading compounds itself. Few participants want to risk looking foolish by trading in a vacuum without clear information. Therefore, illiquidity often leads to greater illiquidity in the aftermath of a precipitous drop.

As a result of these structural and psychological phenomena, one of the key differences that emerges between liquid and illiquid markets is that liquid markets tend to trade in high volumes at both peaks *and troughs*; whereas in private markets, volume is plentiful at peaks but *disappears* at troughs. Since 80% of CRE trades in the private markets (approximately 20% of the value of all U.S. CRE is publicly traded), the private market paradigm generally applies to CRE. In March of 2009, the trough month on the S&P 500 Index, the average daily trading volume on the S&P 500 Index contract was 1.9 billion shares, very close to a volume peak. Likewise, throughout 2007, as this index was peaking in *price*, its trading volume was close to peak levels as well. (Today, the daily average volume is less than one-third of that level.) Many private markets, however, virtually shut down at troughs in pricing. *Quarterly CRE private transaction volume declined by 90% from peak levels in 2007 to the trough in early 2009*.[3]

2 Source: NCREIF, January 2013.
3 Source: Real Capital Analytics, June 2011.

It was late 2010 before CRE transaction volume began to reaccelerate, though it is still meaningfully below peak levels. As a result, *as we approach the five-year anniversary of The Point of Maximum Uncertainty, the CRE markets in the U.S. have not yet cleared.* What does this mean?

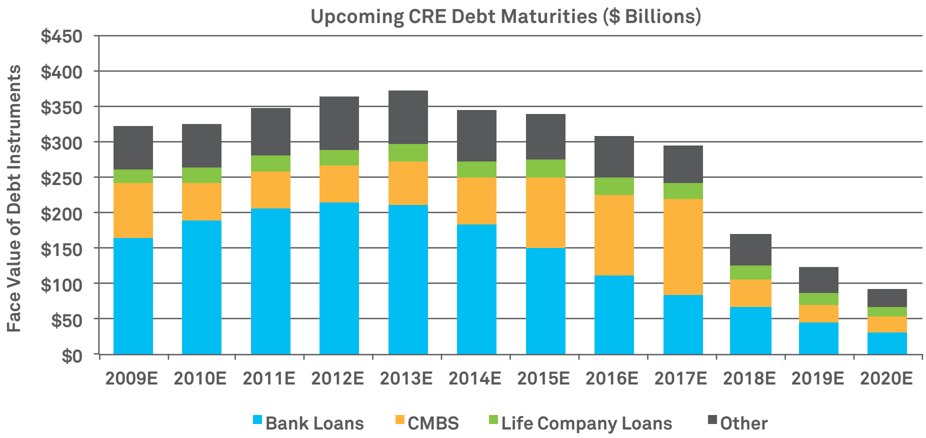
Scheduled maturities of bank loans, commercial mortgage-backed securities, and other forms of real estate debt will peak in the second half of 2013.

Unlike the market for equity interests in public companies, where the bottoming of share prices generally flushes out huge trading volume, positions are remarked without prejudice, and market participants begin the process of resetting psychological expectations and preparing for the new cycle, the private market for CRE assets is still beset by overhangs. You cannot hide from the closing price on the New York Stock Exchange. It is much easier to kid yourself about the value of your partially leased office building. (During this cycle, your lender was just as likely to go along with this delusion.) There is simply not the same mark-to-market discipline in the private markets. Though having the benefit of daily market pricing in the public markets may indeed at times cause investors to overreact, the lack of price discovery in private markets most certainly causes investors to underreact. Individual CRE assets and portfolios, and private, CRE asset-based companies have still not had their day of reckoning where the new reality has been thrust upon owners in the form of realistic valuation marks and new capitalizations.

CAPITAL SCARCITY PERSISTS

This is particularly observable in the markets for CRE debt, where the persistent overhang can be measured in the trillions of dollars. As reflected in Figure 2 below, scheduled maturities of bank loans, commercial mortgage-backed securities (CMBS), and other forms of real estate debt will peak in the second half of 2013.

Figure 2: Maturities Catalyze Opportunity



Source: Trepp, estimate as of December 2012.

Beyond 2013, there remain scheduled maturities in excess of $300 billion for each of the four subsequent years, 2014 through 2017. Most of this debt was underwritten during the peak of the last cycle from 2004 to 2007, when valuations were high and loan underwriting standards were loose, amortization disappeared and interest-only payment terms took its place. The majority of these loans are either under water (the loan is in excess of today's value of the property) or un-refinanceable, given today's lower asset valuations and more restrictive debt covenants. Additionally, a huge portion of the debt that matured during the 2009-2012 timeframe (per Figure 2, in excess of $300 billion per year) has not yet been resolved. It has been "extended and pretended" and still awaits recapitalization and resolution. In other words, *the majority of the problem in CRE is still to be solved and the majority of the distress is still out there, lingering.*

We believe that this overhang of unresolved problems restrains CRE asset price appreciation and creates an opportunistic environment where current CRE owners are only very gradually having their day of reckoning, where they are forced to take painful write-downs or write-offs, as the rescue and refinancing capital is still too scarce and costly. The economy has simply not rebounded quickly enough or robustly enough to bail most of these overextended borrowers out of their positions.

Debt capital formation remains far below peak levels; and although interest rates are low, loan re-financing proceeds levels are insufficient to plug the balance sheet holes created by lower asset values. During the peak years of the last cycle, the CMBS market became, quite clearly, the "dumb money" in the CRE marketplace. As shown in Figure 3, over $200 billion of real estate loans per year were securitized at the peak.

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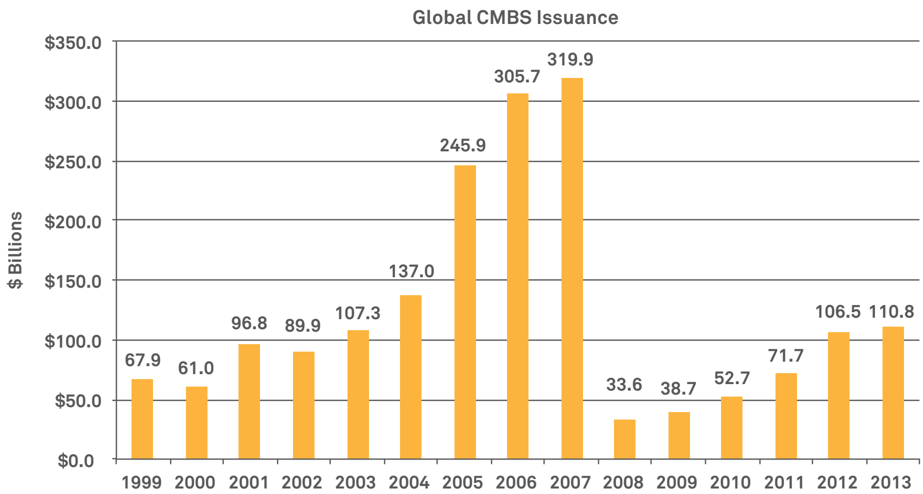
Figure 3: CMBS Underwriting Volume



Source: Commercial Mortgage Alert, September 2013 (2013 shows January through September 2013 data).

After being essentially shut down for most of 2008 and 2009, CMBS underwriting is today a fraction of peak levels, even as that massive volume of peak period loans is now coming due. Clearly not everyone will get the debt capital they need.

Real estate private equity fundraising is no different. As shown in Figure 4, the peak saw private equity fundraising averaging well over $100 billion per year. Each of the last four years have seen significantly less than half those peak levels, and the current pace shows only mild signs of accelerating.

A closer look at the industry today will reveal that this capital scarcity is not the case everywhere.

Figure 4: Global Real Estate Private Equity Fundraising

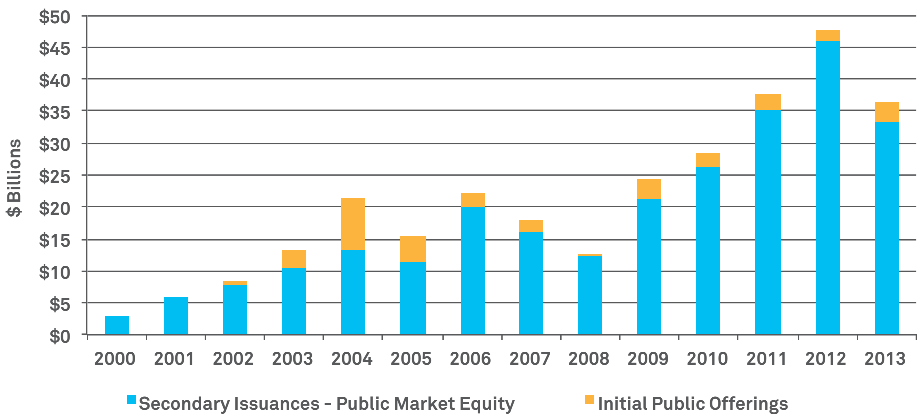
Source: Preqin, September 2013 (2013 shows January through September 2013 data).

The scarcity of equity capital, especially for "opportunistic" strategies, is creating an environment that is defined by more opportunities than capital in the marketplace. Loan maturities, representing demand for capital, are peaking while debt and equity capital raising overall remain far below peak levels.

A closer look at the industry today will reveal that this capital scarcity is not the case everywhere. Industry statistics show that half of real estate private equity capital raising is targeted towards "core" strategies, which generally overlook the vast majority of U.S. CRE assets that fall outside today's narrow, risk-averse definition of core.[4]

The public markets have been the one relative bright spot in CRE capital raising in the U.S., as shown in Figure 5. In the public markets, equity and debt capital raising for REITs has already surpassed 2004-2007 peak levels. Real estate investors have punished many of those opportunity fund managers who pursued overly aggressive, over-leveraged, and ill-timed, illiquid strategies, whereas many investors have increasingly opted for the liquidity and moderate leverage that prevails in the REIT market.

Figure 5: Public REIT Equity Capital Formation



Source: NAREIT (National Association of Real Estate Investment Trusts), September 2013 (2013 shows January through September 2013 data).

4 Source: Commercial Mortgage Alert, January 2013.

However, it is important to note that REITs are, more than ever before, essentially core vehicles. Aside from a few ground-up developments and re-development assets, REITs own stabilized, mostly coastal, major-metro area, upscale, high-quality, fully leased, newly constructed or newly renovated assets in a modest leverage envelope – in other words, the definition of core. So, when combining private and public market equity capital formation, by our reckoning, *75% of the equity raised over the last few years has been looking for core-type exposure.* This leaves very little capital available for problem-solving, non-core strategies – situations where capital itself has the ability to create a tactical advantage.

The typical core buyer only wants to buy assets in a handful of U.S. markets today.

RISK AVERSION DRIVES VALUE OPPORTUNITY

This set of circumstances has set up what we believe to be one of the most compelling relative value opportunities within the CRE sector in recent memory. Most investors, still smarting from the painful memory of 2008-2009, continue to indulge their risk aversion today – at great cost, we believe. They believe that they are avoiding risk by sticking to the conventional wisdom which dictates that core is the way to go – and capital raising reflects this. The problem here is that core is priced for perfection. As we have established, 75% of the incremental capital raised is chasing, roughly speaking, the top quintile of CRE assets in the U.S. today that satisfy all of the core attributes. And if one examines each of these core attributes individually, it becomes clear that each parameter is driven by the aversion to a particular perceived risk.

The typical core buyer only wants to buy assets in a handful of U.S. markets today, specifically, the New York, San Francisco, Washington, D.C., Boston, and Los Angeles metro areas. Why? That is where they think that other investors will continue to fill in behind them and provide greater future liquidity. At best, this is momentum investing and, at worst, reliance on the greater fool theory. Many investors believe that by selecting these markets they are thereby avoiding liquidity risk, of which they experienced the negative impact of 2008-2009. They believe that investors in the future will continue to pay the same or larger premium for these markets as they do today. We believe that there are reasons that they might not. In particular, *we believe that the EBITDA multiple premium that these markets command is already far greater than the actual long-term rental growth advantage that these markets confer.*

Specifically, many investors believe that these markets provide “barriers to entry”, an investment thesis that worked in the 1990s and early 2000s when economic growth was plentiful and there were only a few locations in the U.S. where urban density and regulatory hurdles provided owners of existing assets with some protection from rapid new construction of competitive assets. This thesis is far less relevant today. The problem is that economic growth is the scarce commodity today, and it generally is not located in these favored markets. The financial services recovery in New York City is largely behind us. As is the government-driven demand boom in Washington, D.C. And ironically, New York and San Francisco today have the largest office construction pipelines in the country, so the barrier to entry argument appears muted. In our view, the very marginal benefits that accompany investing in these markets today are generally not worth the steep valuation premium being paid by the core investor. Conversely, there are many markets with above average economic growth and job growth characteristics that are being virtually ignored by investors that are hewing to their outdated geographical prejudices.

With the weight of money directed at these favored markets, the rebound in pricing back to near-peak levels is much further along. As shown in Figure 6, the favorite markets have regained 70% of their lost ground in terms of asset pricing, whereas the rest of the country has only regained one-third of the value lost in the downturn. This is a striking dispersion in asset price performance and demonstrates the effect of the vast bulk of the money concentrating on a sliver of the available CRE asset universe.

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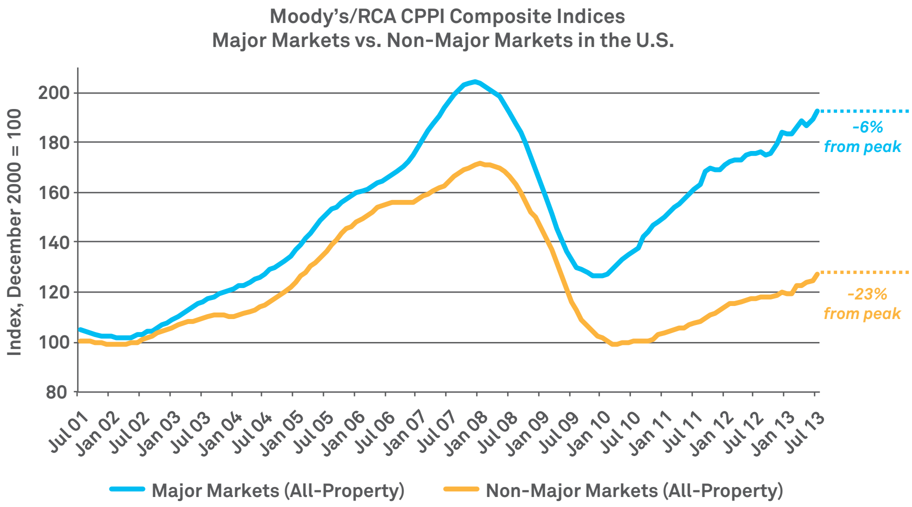
Figure 6: Core Markets vs. Secondary Markets



Source: Moody's/RCA Commercial Property Price index (CPPI) – Core Commercial Composite Index, July 2013. Major U.S. Markets as defined by Moody's include: Boston, Chicago, Los Angeles, New York, San Francisco and Washington D.C.

We see this over and over again every day in the marketplace. Assets in these favored markets attract more bidders at higher prices. Outside these markets, investor appetite falls off dramatically. Whereas an office tower in downtown San Francisco or New York City might easily attract 30 bidders, the same asset in downtown Miami or Atlanta might get three, or perhaps only one, and therefore be much less efficiently priced.

CORE VS. OPPORTUNISTIC

The same risk aversion is observable in relation to an asset's occupancy. Investors, in their stretch for yield, are willing to pay very high multiples on existing rental revenue streams for leases in place. This is all in an effort to avoid "leasing risk". We have seen fully leased buildings trade at 80-100% of replacement cost, whereas the neighboring asset of similar quality might trade at 30-50% of replacement cost when empty. What the core buyer is missing here is that a low basis, at say, 40% or 50% of replacement cost, can eliminate much of the financial risk that would ordinarily be associated with a value-added business plan that incorporates leasing up an empty building. If you own a building at that lower basis, you can fill up your building at below market rents by taking market share from other buildings while still generating a better return on assets and on equity. Lower risk, better return.

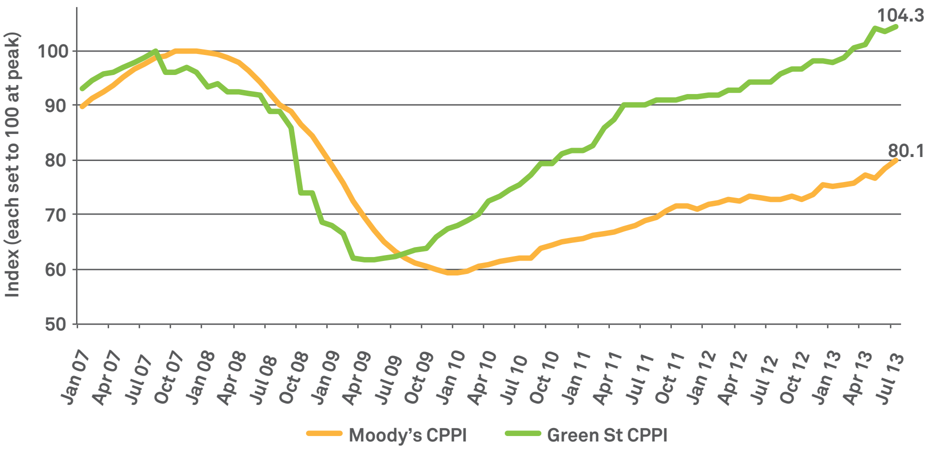
The point here is that core buyers, in their desire to avoid the risks that they perceive, are absorbing the very substantial, but less apparent risks attendant with buying in at a full valuation.

Witness the Green Street Index in Figure 7 below, which represents the value of all the CRE assets that public U.S. REITs own. This index is in essence a proxy for a core index. Compare that to the price performance of all U.S. CRE assets as represented by the

Moody's Index. Core has rebounded rapidly and dramatically as most of the recent debt and equity capital formation has targeted this slice of U.S. assets. Manhattan office buildings, Class "A" shopping malls in affluent areas, fully-leased, major market distribution warehouses and coastal apartments comprise the bulk of this index. This core-proxy index has essentially rebounded to its 2007 all-time high. The broad-based Moody's U.S. Core Commercial property index, which represents all U.S. CRE assets, has only regained roughly one-third of its 2008-2009 drop.

Assets where some lease-up of vacant space is required trade much more cheaply.

Figure 7: Core vs. Opportunistic



Source: Moody's/RCA Commercial Property Price index (CPPI) – Core Commercial Composite Index, Green Street Advisors – Commercial Property Price Index (Green St CPPI), July 2013.

This dispersion represents quite an opportunity. *The core buyer is really being forced to pay up for perceived safety here; and is thereby left with an upside/downside return profile that is not terribly attractive in our view.* From a broad asset allocation perspective, a core real estate strategy does seem attractive today relative to other asset classes. It is certainly not an irrational choice. In a world where an increasing number of other asset classes (e.g., fixed income, hedge funds and equities) have not consistently met most institutions' actuarial return requirements, core CRE is a convenient place to park large volumes of money at, what are today, historically wide spreads over treasuries. We believe, however, that within the context of the overall CRE universe, a core strategy is leaving a remarkable amount of value on the table today for others willing to take a harder look.

Assets that are perhaps not located in the currently favored markets, but happen to be in markets with more dynamic regional economies, tend to be priced much more cheaply today. Assets where some lease-up of vacant space is required trade much more cheaply. Quite often this vacancy relates not to the quality or fundamental desirability of the asset, but to the asset's financial instability resulting from prior-cycle overleveraging and a resultant lack of available capital required to retain tenants and attract new ones – the "zombie building" scenario. Many of these assets can readily be re-positioned with a capital injection and some intensive asset management from a "best in class" local owner/operator.

Aligning the manager with his investors from an exit timing standpoint is of critical importance.

STRATEGY RECOMMENDATION: MANUFACTURING CORE

We believe that the *wide valuation spread between where core assets trade and where everything else trades is highly exploitable.* However, a value-oriented approach requires casting a wide net across all segments of the CRE industry – public, private, debt, equity, domestic, international, primary and secondary markets – in order to find where real estate is trading most cheaply. This requires finding specialist managers that can best access the specific investments within the silos of opportunity that are presenting value. The managers need the skill sets to re-position assets aggressively and fill leasing holes to stabilize cash flow. Structurally speaking, we believe that an investor should endeavor wherever possible to maintain the ability to influence the manager's actions throughout the investment period – in particular, the ability to cease capital deployment once that manager's silo of opportunity is no longer cheap.

Finally, successfully exploiting the arbitrage between core and soon-to-be-core assets requires something that few managers have historically demonstrated: sell discipline. Very few managers, who are by nature micro-focused, alpha-generating, self-described "real estate people", understand that over the course of the cycle, trading multiples peak and therefore real estate values peak long before cash flow at the asset level peaks – too often leaving managers holding assets for too long and past the peak of the cycle. Aligning the manager with his investors from an exit timing standpoint is of critical importance. Size of capital commitment is helpful here in commanding the influence to ensure optimal exit timing, as well as an economic equation that provides for lower management fees and a steeply progressive carried interest structure that rewards higher returns and penalizes sitting on assets. If all these elements are incorporated, it is our belief that the active-minded institutional investor pursuing a real estate investment program today can engineer a very satisfactory experience indeed.

INDEX DEFINITIONS

The S&P 500® has been widely regarded as the best single gauge of the large cap U.S. equities market since the index was first published in 1957. The index has over US$ 5.58 trillion benchmarked, with index assets comprising approximately US$ 1.31 trillion of this total. The index includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities.

The Moody's/RCA Core Commercial Property Price Index (CPPI) are a subset of the RCA CPPI exclusively co-branded with Moody's Investors Services including 20 national level indices that measure price changes in US commercial real estate. Published monthly, these repeat-sales regression indices are calculated by Moody's and based on Real Capital Analytics data. The Moody's/RCA CPPI is the successor to the Moody's/REAL CPPI, the industry's first repeat-sales index, that launched in 2007 and quickly became the industry benchmark.

The Green Street Advisors' Commercial Property Price Index is Green Street's publicly available index that estimates monthly changes in U.S. property values. The index provides a time series of unleveraged U.S. commercial property values that captures the prices at which commercial real estate transactions are being negotiated and contracted. This index is differentiated by its timeliness and weighting.

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