What investors need to know about . . .

Grape Expectations: Investors Should Not Drink the Cool-Aid

Research Provided By:
Zisler Capital Views

"Take nothing on its looks; take everything on evidence. There's no better rule."
— Charles Dickens, *Great Expectations*

"A central lesson of science is that to understand complex issues (or even simple ones), we must try to free our minds of dogma . . . Arguments from authority are unacceptable."
— Carl Sagan, *Billions & Billions: Thoughts on Life and Death at the Brink of the Millennium*

"It is difficult to get a man to *understand* something, when his salary depends upon his not understanding it!"
— Upton Sinclair, *I, Candidate for Governor: And How I Got Licked*

Introduction and Summary

Dogma, or received wisdom, can, and often does, blind the otherwise discerning investor, especially when the investor must report to institutional investors and their investment committees. "Drinking the Cool-Aid", which usually pertains to those holding an unquestioned belief without critical examination or introspection, can also refer to endorsing knowingly or supporting reluctantly a doomed or dangerous idea because of peer pressure, so-called expert opinion, or the money management equivalent of acting in a flagrantly arbitrary and self-serving fashion. Authority trumps evidence under pressure!

This essay addresses three issues: The first is the extent to which return expectations have ratcheted downward; second is the need to recognize and embrace these changes, and the third is how investors can still invest profitably in a maturing market.

The following are some highlights.

- We believe that mispricing and risk-illusion are now a pervasive phenomenon in maturing commercial real estate markets. Return targets are too high and investors are not focusing with sufficient care on relative value. In fact, we now fear an emerging bubble[1]—admittedly hard to detect with certainty—during which investors relax underwriting

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Encore Enterprises, Inc.

Corporate Office:
5005 LBJ Freeway, Suite 1200
Dallas, TX 75244
214-259-7000
www.encore.bz

standards and fail to adequately differentiate and price risk.[2]

- Investors should adjust their strategies and reduce their return expectations downward. Real estate investor return expectations (and performance) have deteriorated since 2011 for every major property types, including office, retail, industrial, and apartments.

- Many institutional investors, who have yet to recognize the in-process reduction in return expectations across all major property groups, continue to drink the cool-aid and hope longingly for a return to the halcyon days of low-hanging fruit. This recalcitrant (but naively hopeful) group still resists adjusting its targeted returns downward. More realistic investors have already confronted, if not happily embraced, the evolving new reality and, as a result, they are busy closing transactions.

- In a novel analysis of the PREA quarterly expectations survey data, we show that multi-year total return expectations have indeed declined. Some of the largest (and, we are told, more sophisticated) real estate managers participate in this survey. Expectations have mostly under-performed actual performance. In every year, including 2010, a year of rising expectations, and the following years of declining expectations, actual performance exceeded expectations. Recently, however, actual performance and expectations are converging at lower return levels.

- Have some survey respondents purposely "low-balled" or "managed" investor expectations and, hence, attempted to manipulate their end-of-year performance evaluations? Have some turned a blind eye to risk? Some respondents may have.[3] However, we believe that the data are still a valid indicator of a downward return expectations trend.

[1]Transactions volume and capitalization rates have recovered to near 2007 pre-Crash levels.

[2]We now worry that the real estate risk premium is too small. This concern is especially important when contemplating whether cap rates are too low and too susceptible to changes in interest rates. Cap rates are a function of the risk-free rate, the risk premium (or spread), and the expected growth rate of NOI. Even if interest rates rose, we argued last year, an increasing growth rate would offset any likely increase in interest rates. Since we believe that spreads have narrowed and expected rental growth rates has not improved significantly, cap rates are more vulnerable to upward movement in interest rates today than they were last year. We believe that this vulnerability is greatest for core-like property in certain institutionally favored markets.

[3]Downward pressure on fees and expected returns can cause some, but not all, investors and their sponsors to assume, and even hide, risk. This behavior is related to style drift in which a sponsor or manager may change the overall risk of its normal acquisitions or dispositions half way through the year, for example, in order to preserve or boost average returns. Disguising risk is one way to achieve this objective. Successful opportunistic advisors might shift to low risk acquisitions in order to preserve superior mid-year returns, whereas a poorly performing core investor might seek higher risk assets to boost performance.

- Investors who have not reset their expectations are consummating fewer deals and are less competitive. This behavior may endanger smaller, less well-capitalized, emerging managers operating below their break-even points. We believe that the overall property market has matured and hovers around a point of inflection. For certain property categories and locations, value-added may offer the best risk-adjusted return; in other cases, opportunistic investing dominates.

- Many core investors who regard core-risk as largely embodied in lease default risk may imprudently be ignoring exit cap rate risk. Long-term core investors who enjoy the optionality (and risk mitigating effect) of a flexible sale date and who regard core-like real estate as a near-perpetual bond substitute with additional spread may find core and core-plus investing more compelling. <u>However, at this time, we do not believe that core-like investing generally offers the most attractive risk-adjusted returns, especially if compared with value-added and opportunistic investing.</u> Furthermore, we believe that credit spreads are too narrow for some core property.

- Transactions volume is increasing and capitalization rates have fallen to near 2007 pre-Crash levels, reflecting the re-infusion of massive amounts of liquidity. This inflow, however, is not balanced: Capital inflows, especially flows into LP (limited partnership) capital stack positions, have depressed overall expected LP returns. Exacerbating this problem is the lack of commensurate growth in GP capital, thus creating a <u>GP funding gap. The inelastic complementarity of LP and GP capital is a precondition for a funding gap, which is impairing the ability to invest LP capital. Hence, we believe that GP risk-adjusted expected returns may have increased relative to LP returns and, in many instances, the GP position, especially for value-added and opportunistic investments, may now offer superior risk-adjusted returns, especially since GP capital is high-octane fuel.</u>

- Institutional and some ultra-high net worth investors (and their family offices) should consider increasing their allocation to GP investments, especially if they have no GP exposure. However, since GP capital is a small piece of the capital stack, GP investing may not "move the needle" much for large institutions with pressure to invest large amounts of LP capital.

What is driving the reduction in return expectations and can investors still find attractive real estate investments?

Heated Markets, *Redux*

Transaction volume is approaching pre-Crash levels, especially for non-office properties. The rise in total transactions volume, as shown in Exhibits 1 and 2, reflects the re-infusion of massive amounts of liquidity, which in turn has fueled cap rate compression. Lower cap rates imply that investors must revise their return expectations downward. Pursuing non-traditional, capital starved sectors and strategies may be a way to mitigate the corrosive effect of reduced expectations.

Exhibit 1. Transactions volume has risen dramatically

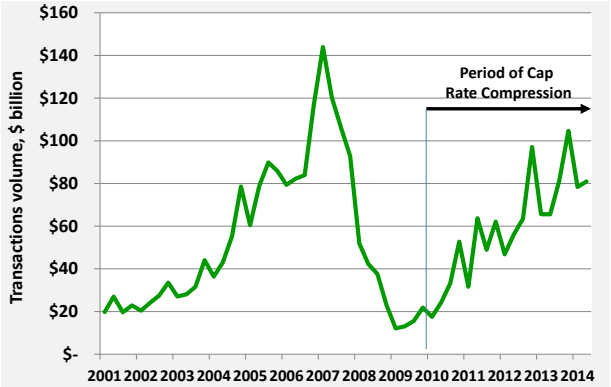
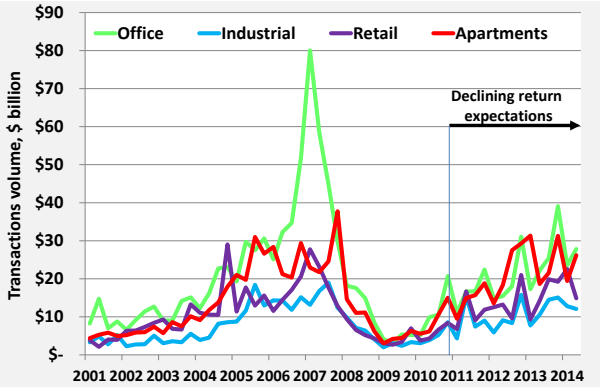


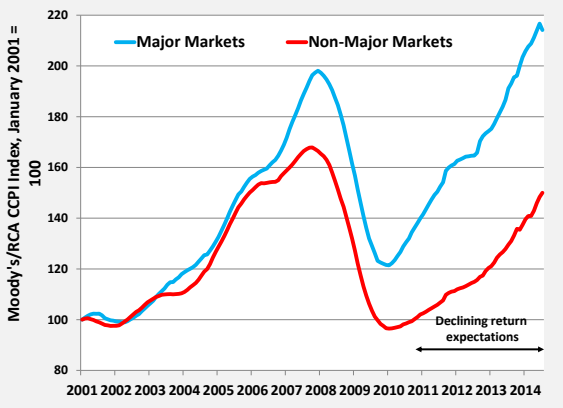
Exhibit 2. All major property group transaction volumes have increased



Source: Real Capital Analytics

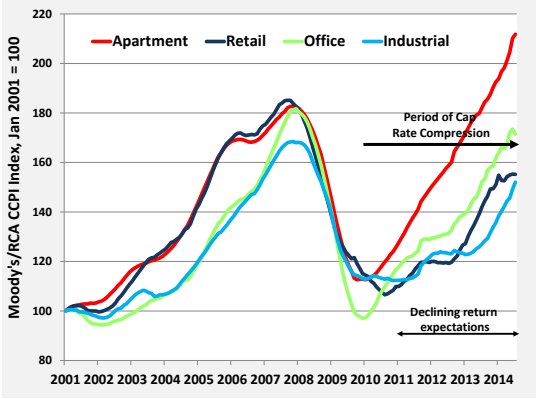
Investors, as early as 2008, have emphasized major markets, especially so-called Gateway or Primary Cities, often for questionable reasons, including herd mentality and all too casual empiricism. For example, Exhibits 3 and 4 indicate that the growth and levels of property values in major markets have significantly exceeded that of non-major markets. Apartment values rose at a rapid rate well before the values of other property types. The rate of ascent matches the pre-Crash pace.

Exhibit 3. Property values have recovered and will soon exceed 2007 record highs.



Source: Moody's/RCA CPPI™

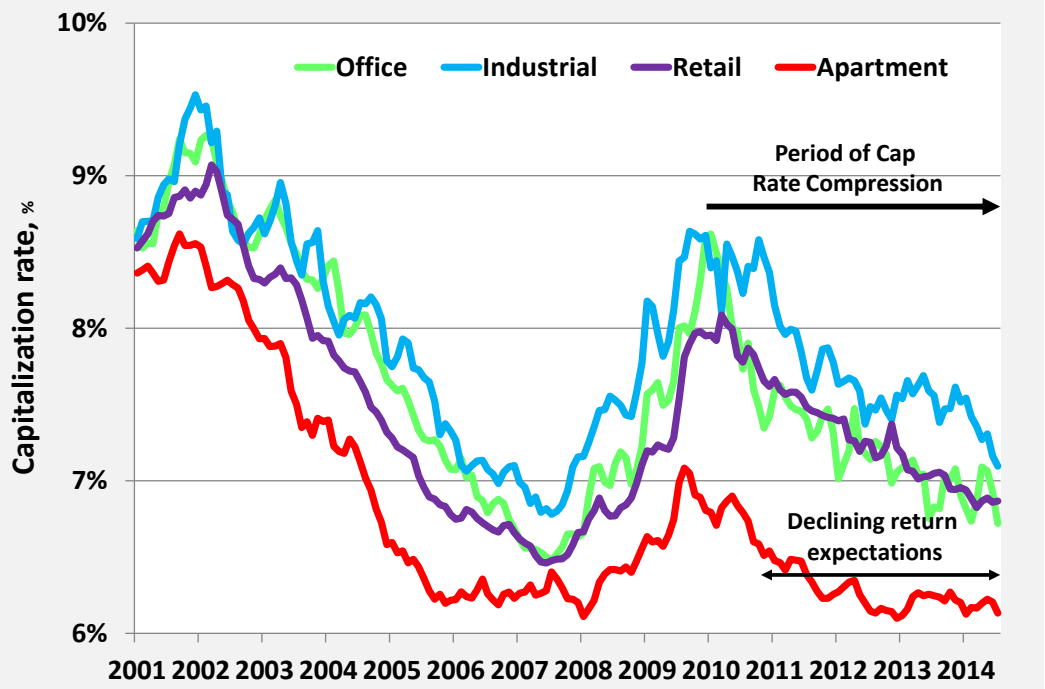
Exhibit 4. Apartment values now exceed their 2007 peak.



Source: Moody's/RCA CPPI™

Cap rate compression is approaching pre-Crash levels.[4] Exhibit 5 indicates that apartment cap rates are already at 2007-2008 lows. Retail, industrial and office are near 2006-2007

Exhibit 5. Capitalization rates are approaching 2007-2008 levels.



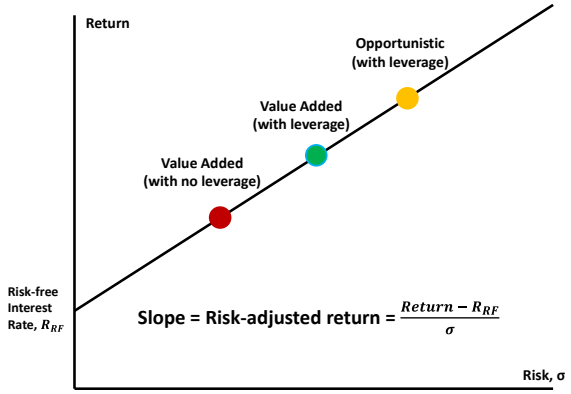
levels. How should investors react to the spread compression? Investors should reconsider how they invest in real estate, not whether they ought to do so. Moreover, they should be mindful of the fact that return expectations have declined. This alone requires a reassessment of real estate in relation to other asset classes.

[4]As we noted above, credit spreads have shrunk, especially in the case of apartments. Hence, cap rates may be more vulnerable this year to unexpected increases in interest rates. If this be the case, then investors may want to consider strategies wherein interest rate shocks are likely to have a less deleterious impact. We believe that there are many such strategies, some of which include value-added instead of core acquisitions and investments in secondary and tertiary markets. The securities counterpart to this point is that an unexpected interest rate shock often has a greater impact on AAA -rated corporate bond returns than on BBB-rated and junk bond returns.

Successful investing rests upon proper conceptual foundations. There are few concepts which are as important, and poorly understood, as risk-adjusted return. This section discusses what we mean by "risk-adjusted"[5] and shows how the concept can help us think about investment style and relative value in the capital stack.

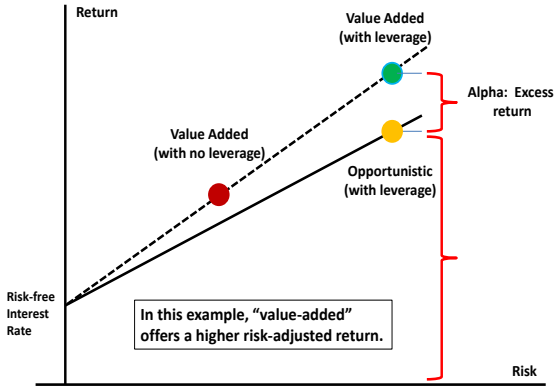
Markets are seldom in equilibrium; mispricing is pervasive.[6] By contrast, when markets are in equilibrium, each asset should have the same risk-adjusted return, which is the difference between the asset return and the riskless rate divided by risk, or the standard deviation, as shown in Exhibit 6. Opportunistic investing is riskier than value-added, even though they both have (in equilibrium) the same risk-adjusted return (or identical slopes for the capital market line).

Exhibit 6. When markets are in equilibrium—a rare event—then risk-adjusted returns, the slope of the securities market line, across all asset classes should be the same.



Source: Encore Enterprises, Inc.

Exhibit 7. Markets are seldom in equilibrium. Either value-added or opportunistic may offer the dominant risk-adjusted return and higher alpha due to active management.



Source: Encore Enterprises, Inc.

Contextual Investing.[7] We believe that the world is grey and disorderly, and risk-adjusted returns vary, although in a relatively efficient market, through the action of arbitrage, risk-adjusted returns converge to equality. Buying assets with greater expected risk-adjusted

[5]One well known manager argued that in the case of private real estate equity (property) there is "no such thing as 'risk-adjusted return'". We would retort that the absence of evidence is not evidence of absence. See Upton Sinclair quote at the beginning of this paper.

[6]Many investment managers believe that just because asset mispricing exists, they can systematically exploit this mispricing. We are doubtful. The instability of manager performance rankings suggests that systematically beating the market (after fees) is not a challenge for the faint hearted, even in so-called inefficient markets.
[7]It just depends! There are no absolutes.

returns and selling the rest is the secret of successful investing.[8] The hypothetical example in Exhibit 7 shows that in a mispriced market an unleveraged value-added investment (in red) may have a lower return (and standard deviation) than an opportunistic deal (yellow), but, if we leverage the value-added deal to the point where the riskiness of the leveraged value-added and opportunistic deals are equal, we then observe that the leveraged value-added deal (green) produces excess return and exhibits a higher risk-adjusted return (non-zero alpha). The steepness of the capital market line is an indicator of risk-adjusted return: The greater the slope, the higher is the risk-adjusted return. Use of risk-adjusted return and judicious adjustment for leverage helps the investor compare alternative investments.[9]

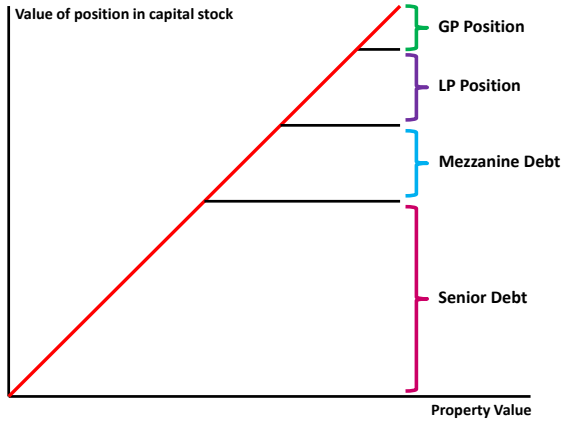
Market observation: We believe that the overall property market has matured and hovers around a point of inflection. For certain property categories and locations, value-added may offer the best risk-adjusted return; in other cases, opportunistic investing dominates. Long-term investors who enjoy the optionality of a flexible sale date and who regard core-like real estate as a bond substitute with additional spread may find core and core-plus investing more compelling. However, at this time, we do not believe that core-like investing offers the most attractive real estate risk-adjusted returns; in fact, core values may be more sensitive to increased interest rates than they were last year.

We can apply the same concept of risk-adjusted return to the capital stack as well. Exhibit 8 shows the capital stack, which consists of (for the purposes of this hypothetical example) senior debt, mezzanine debt, LP equity, and GP equity. Pure leveraged equity is the riskiest in terms of absolute risk, but not necessarily risk-adjusted return—remember, markets are seldom in equilibrium!

[8]This approach is nothing more than buying low and selling high.

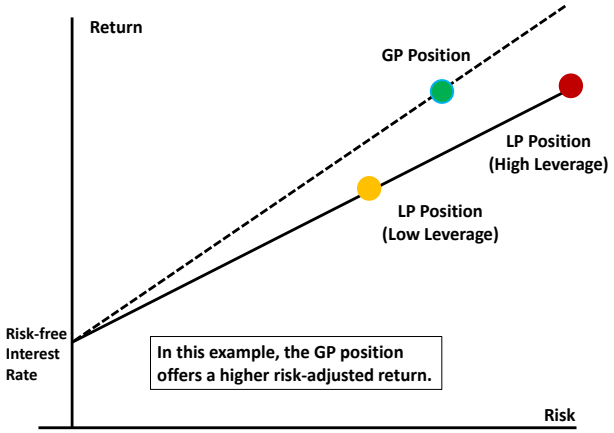
[9]Simple in theory, the application is challenging in practice and is always the source of vigorous debate. Of course, leverage is a subject of abuse, and therefore controversy, especially in those instances wherein a sponsor attempts to "enhance" expected returns by assuming greater risk. The additional risk is often intentionally opaque to the investor.

Exhibit 8. Since markets are not often in equilibrium, any place in the capital stack can offer superior risk-adjusted returns.



Source: Encore Enterprises, Inc.

Exhibit 9. In the example, the GP position, compared to the LP position, offers a superior risk-adjusted return.



Source: Encore Enterprises, Inc.

We would suggest that there are times—and today may be just such a time—when the GP position offers a higher risk-adjusted return even though in certain cases the absolute risk (standard deviation) of the GP position is greater than that of the LP position. We will discuss why a possible imbalance in GP and LP capital today leads us to this conclusion.
Exhibit 9 shows a hypothetical example in which the GP position has a higher risk-adjusted return compared to either the unleveraged or the leveraged LP position.

IV. The Allegory of the Right- and Left-Handed Shoes

LP capital for value-added and opportunistic deals is ample and, assuming that GP capital comprises 10% of total equity and the loan-to-value ratio is about 65% to 70%, LP capital far outstrips GP capital. GP capital is the binding constraint. Without adequate GP capital to expand the capital stack and utilize available LP capital, prices may peak early.

[10]The GP position may be riskier in absolute terms than the LP position due to its earlier funding, dead deal cost exposure, and pursuit costs. In some cases, the LP investor may be able to remove the general partner. Otherwise, if *pari passu*, the GP position is of equal risk with a likely higher return due to a promoted interest. In practice it may be hard to identify an instance where the GP does not have a higher risk-adjusted return.

[11]Encore is continually buying and selling value-added and opportunistic investments. While there would seem to be little public quantitative data available to test these and other hypotheses, our recent experience—empiricism in the trenches—raising GP and LP capital give us comfort that our views in this regard are well-founded. Before accepting this proposition on its face, read the first and second quote at the beginning of this paper.

[12]An allegory is a picture that can reveal a hidden meaning, typically a moral, political or financial truth.

The allegory: The analogy to the market for LP and GP capital is a mismanaged shoe business wherein the cobbler has inadvertently manufactured many more left-handed shoes (LP capital) than right-handed shoes (GP capital). Every additional right-hand shoe produces a finished pair of shoes. For every right-handed shoe, there must be a left-handed one—a right-handed shoe is 50% of a pair. GP capital is similar, except that the GP position is often only 10% of the equity and the total LP and GP equity is 30% to 35% of the capital stack. Since GP capital is a small portion of the capital stack and the GP constraint is binding[13], a small amount of additional GP capital can have a huge marginal value, well in excess of any fees that the sponsor of a GP fund might normally charge. The GP is essentially high-octane fuel.[14]

We now present a plausible hypothesis that explains the current market imbalance. [15]

Since the supply of LP capital is plentiful and growing—managers today are raising record amounts of LP capital—LP returns are dropping even though the demand for LP capital has increased. (See Exhibit 10.) Returns have dropped but transactions volume has increased.

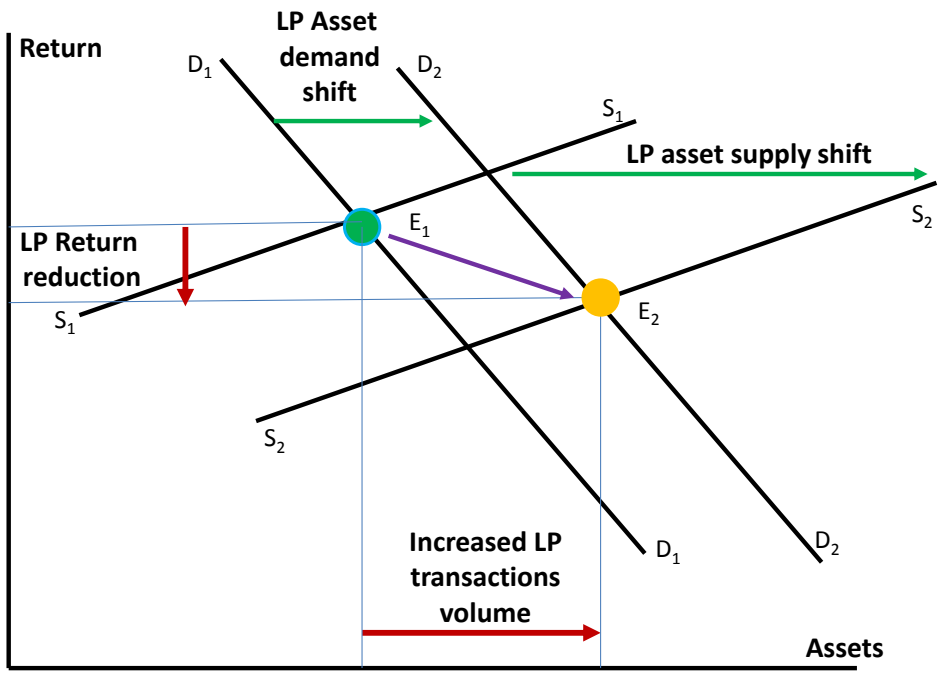
By contrast, we believe that in some markets the supply of GP capital has not increased sufficiently to accommodate the strong growth in demand. Hence, as shown in Exhibit 11, the expected return of GP capital has dramatically increased. GP capital is truly high-octane fuel!

[13]Think of a constrained optimization problem in which the sponsor seeks to maximize the NPV of the company. Constraints, not all of which are usually binding, can include the maximum amount of GP capital, the maximum amount of LP capital, the ratio of LP to GP capital, the number of potential deals in which to invest (deal flow), working capital, etc. If the GP capital constraint is binding, then the shadow price of GP capital is greater than zero and represents the incremental NPV if the GP constraint is relaxed by one dollar. If, as a result, the NPV increases by $0.70, then the shadow price of GP capital is 70%, even though the targeted market GP return is in the mid-twenties. If the number of deals is plentiful and GP and LP capital are not binding, then the shadow price—not the market price—of capital is zero.

[14]An instructive analogy is losing the key to a high performance car. Retrieving or replicating the key, the cost of which is trivial, can make all the difference between a lost weekend and a thrilling ride with someone special.

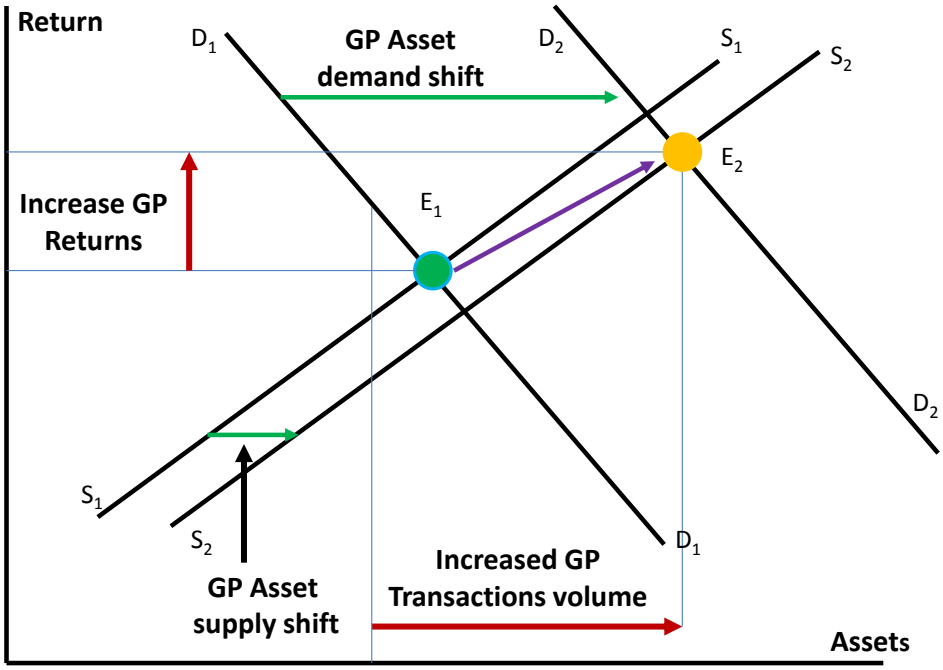
[15]We regret the absence of fresh, copious data with which we could rigorously test our hypothesis. Our substantial econometric tool box awaits the appropriate data and the eventual moment of proof. However, from the vantage point of greater-than-casual empiricism, our analysis seems consistent with recent deal experience.

Exhibit 10. The shifting demand for and supply of LP capital have reduced the equilibrium LP return and increased transactions volume.



Source: Encore Enterprises, Inc.

Exhibit 11. The shifting demand for and supply of GP capital have increased the equilibrium GP return and increased transactions volume.



Source: Encore Enterprises, Inc.

The irony, we believe, is that the opportunity cost of GP capital (marginal return of an additional dollar of GP capital) has increased even though real estate (mostly LP) investor property return expectations have declined since 2010.

Managers have raised significant amounts of LP capital. However, if GP and LP capital are rigidly complementary[16]—GP capital's percentage share must be within a narrow range, such as 5% to 10% of the equity—and GP capital is scarce in relation to its minimum required share of the overall capital structure, then inadequate GP capital can impair the ability to invest LP capital fully. Excess LP capital is a result.

The next section addresses this important observation.[17]

V. Forward Return Expectations

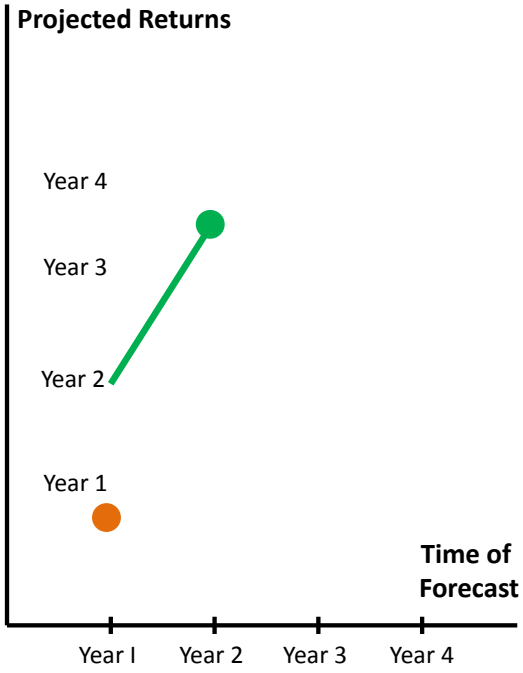
This section documents the persistent decline in forward real estate (property) return expectations. We devise a novel representation of return expectations surveyed and collected since 2010 by the Pension Real Estate Association.

In the second quarter of 2014, twenty-four firms participated in the survey. They represent some of the most prominent and sophisticated institutional money managers in the real estate industry. Respondents in 2014 provided their forecast of total, income and appreciation returns for 2014, 2015 and 2016 for apartments, office, industrial, retail, and all four property categories combined.

[16]"Rigidly" means the elasticity of substitution between GP and LP capital is much less than one. The elasticity of substitution refers to the percentage change in the relative proportions of LP and GP capital relative to the percentage change in the all-in cost of capital of LP and GP capital. We believe that this concept from neoclassic economic theory has not been applied in practical terms to transactions capital structure.

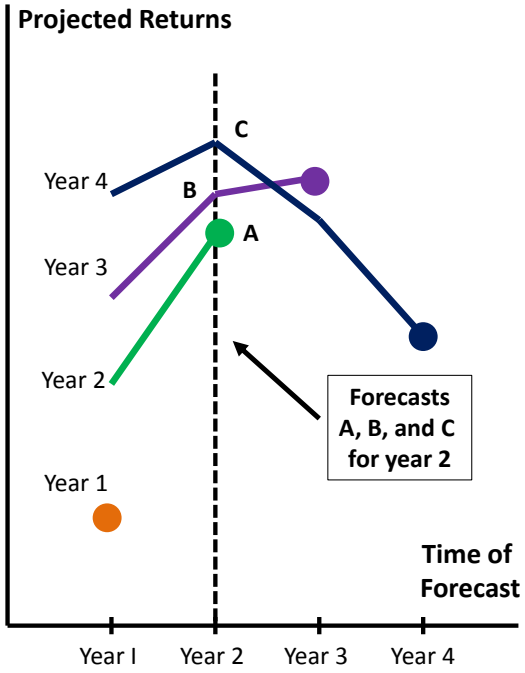
[17]Many institutional investors hesitate to invest in the GP position. The imperative to "get out the money" may be a reason.

Exhibit 12. Forward expected returns for the end of Year 1 and for Year 2 (beginning and end).



Source: Encore Enterprises, Inc.

Exhibit 13. Forward expected returns for Years 2 (end), 3, and 4 as seen from Year 2. Investors see a rising market in Year 2.



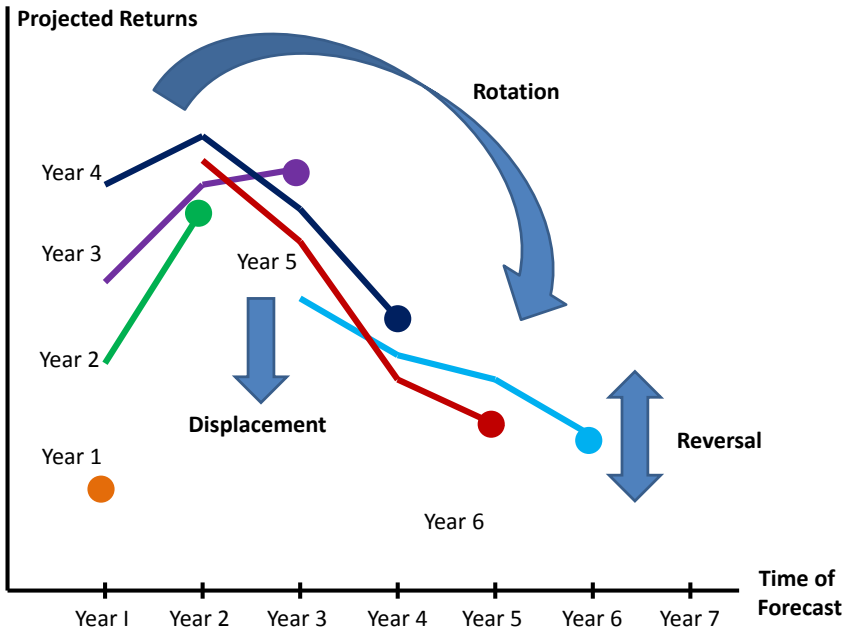
Source: Encore Enterprises, Inc.

Our approach is novel. Rather than report each survey as a slice through time, we stitch together the survey results to show the gradient of change. This technique highlights what may be in real estate the closest we get to a forward equity return expectations curve.

Exhibits 14 and 15 are hypothetical examples, which we use to introduce and define the concept of forward expectations. The first graph shows the results of two surveys, one in year one and other in year two: The year one forecast includes the end-of-year-one forecast (orange dot) and the year two forecast. The year-two survey includes just the end-of-year-two forecast (green dot). Exhibit 15 is a bit more complicated but incorporates the same concepts, this time including a four-year forward forecast (blue) and a three-year forward forecast.

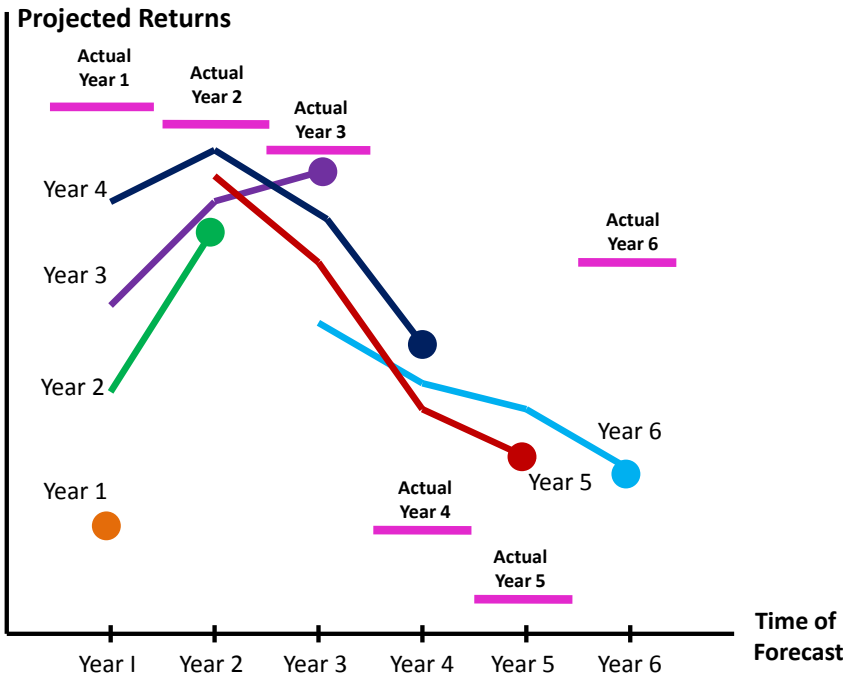
The year-two survey (dashed line) indicates that property returns are expected to increase from year-two through year-four—Point C is greater than Point B and Point B is greater than Point A. However, note that from the perspective of year-three, the end-of-year-three return is expected to exceed year-four returns. The ranking of forward return trajectories changes after year-two and market optimism deteriorates.

Exhibit 14. Hypothetical expected returns (forward curve) over multiple years. Falling expectations dash rising expectations.



Source: Encore Enterprises, Inc.

Exhibit 15. Hypothetical performance and expectations. The market can be short-run myopic with regard to actual performance.



Source: Encore Enterprises, Inc.

An even more complicated hypothetical juxtaposition of survey results, Exhibit 14, shows that beyond year-one, the ranking for forward return expectations change in various ways. The slopes rotate and become negative. The forward forecasts change rankings and translate downward. This picture of declining expectations is characteristic of a mature market or a point of inflection.

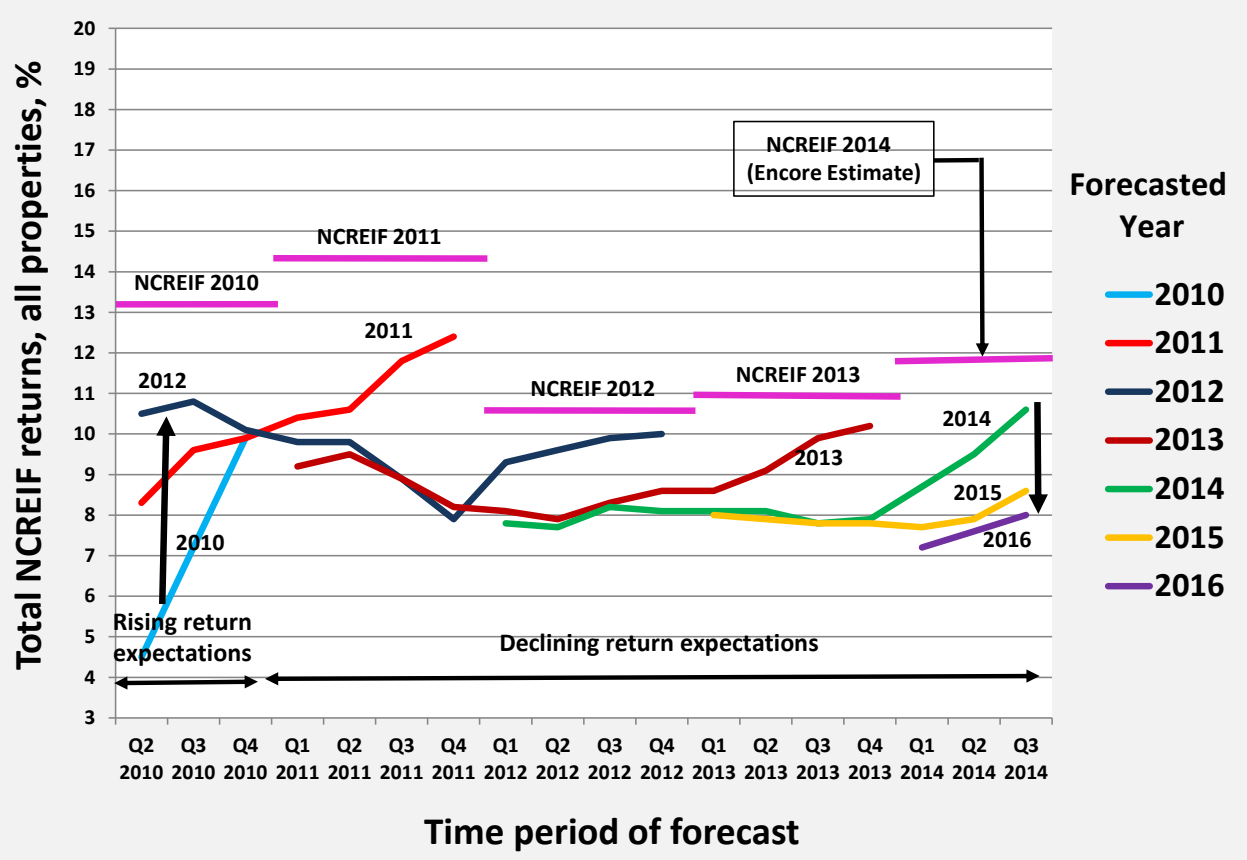
How accurate are forward expectations? Exhibit 15 shows a hypothetical example wherein expectations fall short of actual performance in years one, two, three and six. Expectations in years four and five, which are years of consolidation and declining expectations, are nevertheless too optimistic.

These are hypothetical examples. What is the actual record? Exhibit 16 shows all-property expectations. In every year, including the year of rising expectations and the following years of declining expectations, actual performance exceeds expectations.

Survey respondents systematically (but not necessarily intentionally) "low ball" forward return estimates. This raises questions. Are the survey respondents purposely managing investor expectations or is the "market" systematically biased? If there is systematic bias, does the direction of bias change? We lack sufficient information to comment.

In second quarter of 2010, respondents are aggressively optimistic as the market climbs out of the Crash. By 2012, the story is one of moderation. In the third quarter of 2014, return expectations decline from 2014 through 2016.

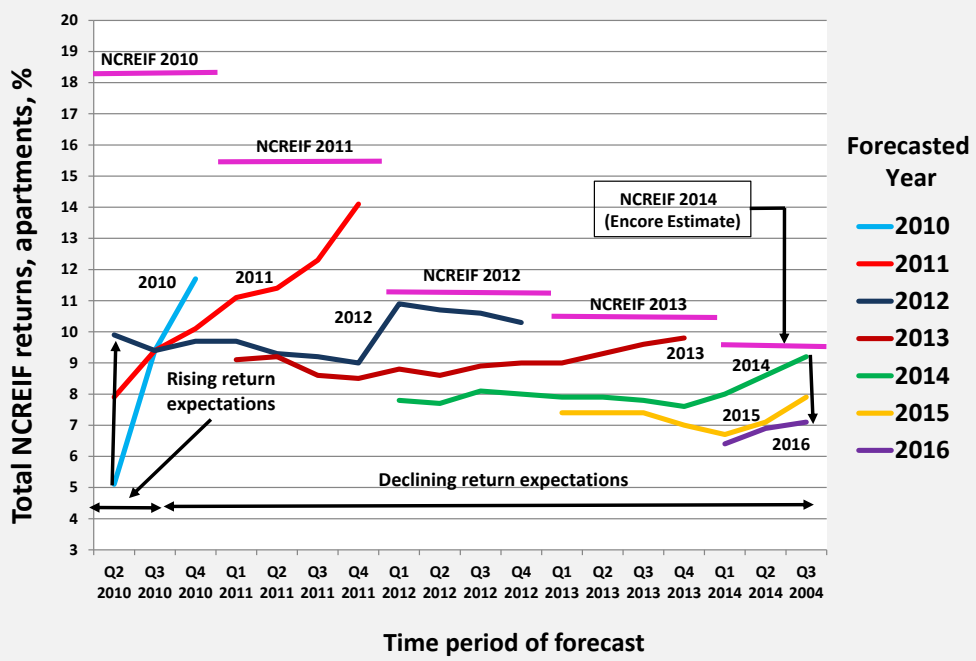
Exhibit 16. All property investment expectations and actual performance



Source: Encore Enterprises, Inc., data from Pension Real Estate Association

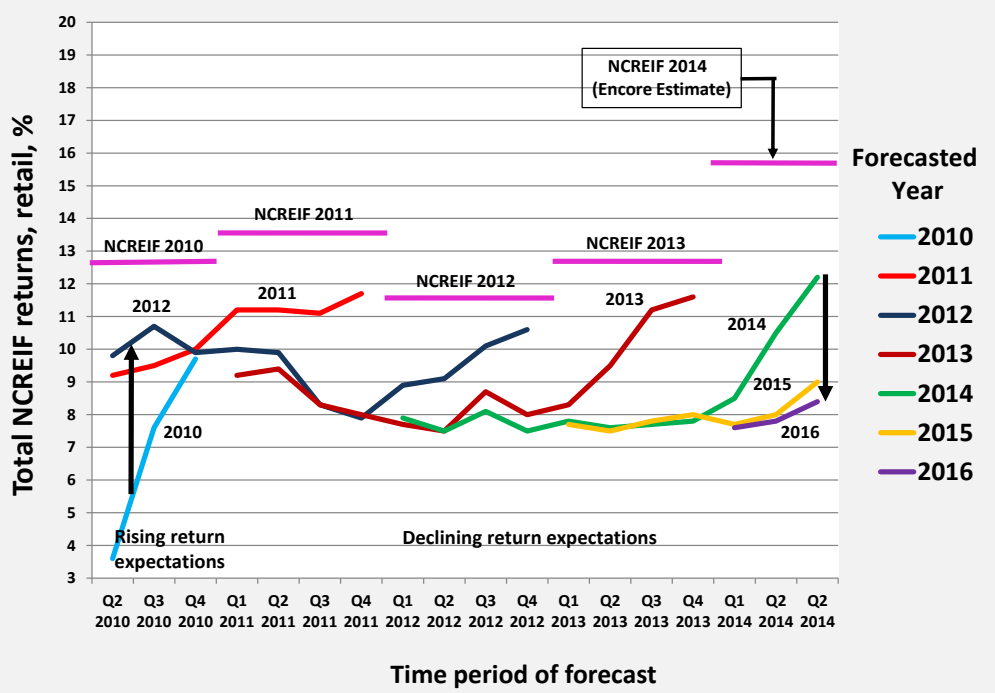
Exhibits 17 through 20 convey a similar story for apartments, retail, office and industrial. In all cases, 2014 is a year of declining forward unleveraged total return expectations.
In the case of apartments, as shown in Exhibit 17, in the second quarter of 2010, investors expected rising returns, with returns in 2012 (dark blue) exceeding those in 2011 (red) and 2010 (light blue), respectively. The rising red line shows that in subsequent quarters revised their expected 2011 return performance upward. Expected returns in 2011 remain dominant through the end of 2011. Moreover, actual returns in 2010 and 2011 exceed expectations. Actual performance and expectations decline as well as converge after 2011. Note the reduction in actual NCREIF apartment performance from 2010 through 2014 (estimated).

Exhibit 17. Apartments return expectations in any one year have become less aggressive, thus downgrading expected growth.



Source: Encore Enterprises, Inc., data from Pension Real Estate Association

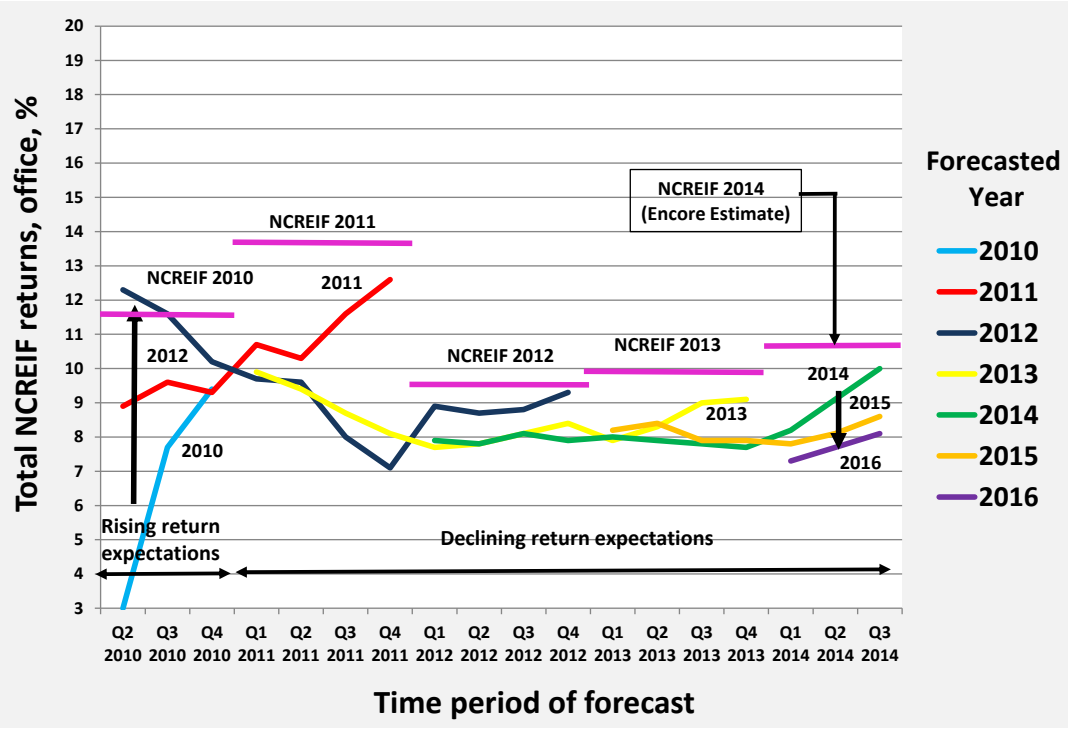
Exhibit 18. Retail return expectations in 2014:III indicate lower performance through 2016 although Encore forecasts stronger actual end-of-year performance in 2014.



Source: Encore Enterprises, Inc., data from Pension Real Estate Association

Office expectations have been lackluster since 2011 and have not changed much until recently. Expectations for 2014, and 2015, and 2016 are tightly clustered as of the third quarter of 2014 but indicate some erosion. We believe that actual performance will be marginally stronger than surveyed expectations.

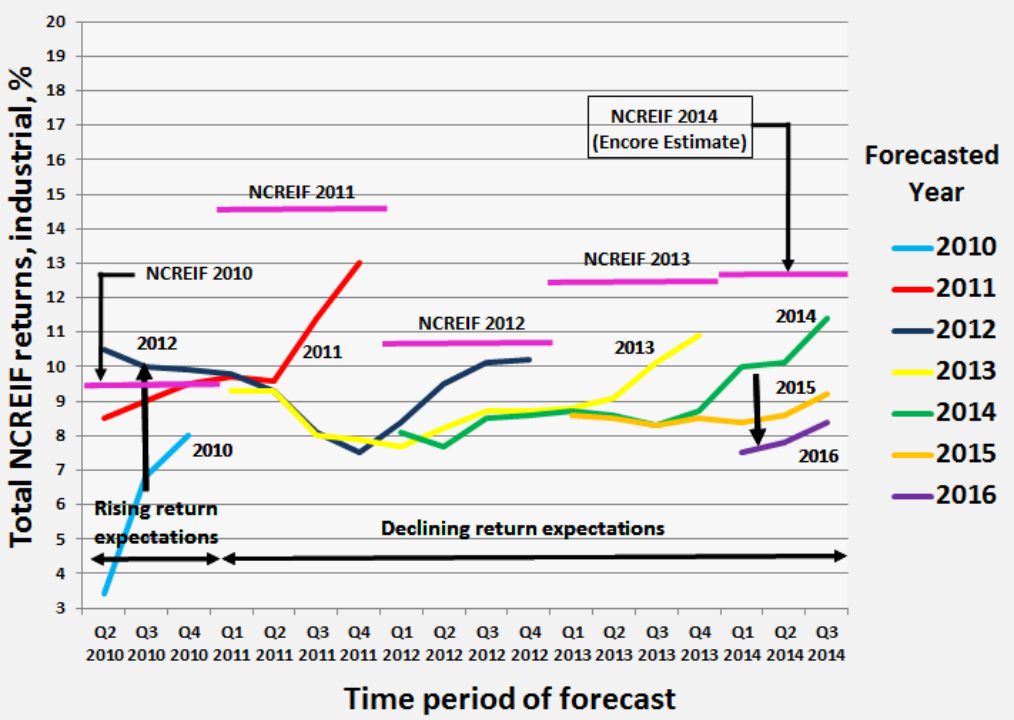
Exhibit 19. Office return expectations in 2014:III indicate lower performance through 2016 although Encore forecasts stronger actual end-of-year performance in 2014.



Source: Encore Enterprises, Inc., data from Pension Real Estate Association

Industrial property expectations exhibit a similar pattern in Exhibit 20. Again, we believe that expectations, which show 2015 and 2016 underperformance relative to 2014 performance, may be too negative. We expect that actual 2014 performance will exceed expectations.

Exhibit 20. Industrial return expectations in 2014:III indicate lower performance through 2016 although Encore forecasts stronger actual end-of-year performance in 2014.



Source: Encore Enterprises, Inc., data from Pension Real Estate Association

In summary, expectations have trended downward but these expectations have mostly underperformed actual performance. [18]

VI. The Great Consolidation and Fee Compression

How should investors navigate an environment of declining return expectations? Can discerning investors make money during a period of consolidation? We say, yes?

The challenge to success is finding attractive and unexploited niches in a mature market, be these niches oases of unexploited excess returns defined by location (secondary and tertiary cities), strategy (value-added or opportunistic), and position in the capital stack (GP and LP).

We now review the current real estate fundraising environment. The size concentration of real estate money management firms is increasing because many pension funds, especially the public funds, do not want to increase the number of managers commensurately with the

[18] A decade of additional data will likely confirm that this pattern is typical of a maturing market.

ineluctable growth of pension fund assets. Unfunded liabilities and possibly reduced total unleveraged return expectations are reasons why pension funds want to stem the growth of staff, reign in administrative expenses and cut manager (and joint venture partner) fees. Thus, emerging managers—first time fund raisers—are facing strong headwinds as they attempt to raise capital. Their small scale is a distinct disadvantage due to high break-even points and fee compression.

The fund raising environment for managers has become extremely competitive.[19] At the ultra-high AUM range, the market has become increasingly oligopolistic. As a result, some smaller fund managers have closed their new fund well short of the target AUM , extended the capital-raising period, merged with other managers, and just exited the business.

Most of the largest AUM accumulators are reaching for yield but many lack the internal capabilities to pursue value-added or opportunistic investments. Hence, many of these managers seek to hire third party leasing agents and other professionals. However, as a rule, when pursuing complex value-added and opportunistic investments, these managers must enter into joint ventures with best-in-class real estate operators.[20]

Value-added and opportunistic operators must contribute often at least 10% of the equity as a co-investment. Since "institutional quality" operators, in our view, are in relative short supply, the managers, especially the larger, well established managers, are directing significant LP capital to real estate operators. The managers, having raised record amounts of capital, are straining to put the capital to work prudently. However, even the well-capitalized (financially strong) operators are struggling in some cases to supplement their GP co-investment capital with third-party contributions at the GP level, sometimes through GP commingled funds.

Managers, often acting with third parties through value-added and opportunistic joint ventures, are seeking larger transactions in order to boost transactions volume and to exploit scale economies in a low-fee-environment. However, many of these transactions are heavily marketed and, hence, fully priced. Thus, many non-core buyers are increasingly emphasizing off-market opportunities, and initially structuring these transactions as all-cash deals in order to close quickly. Until expectations moderate, managers and operators will struggle as investors demand lower fees.

<u>Consistent with aggressive transactions pricing, investors should reduce their return</u>

[19]The most precise term is "rivalrous" if oligopoly characterizes the market. An oligopoly is a market or industry in which a small number of firms dominate a market. AUM is highly concentrated in the institutional real estate money management business.

[20]While there are many developers, those suitable for institutional money managers are a small sub-set.

VII. Conclusions

The market has matured and even peaked in some markets for certain strategies. Even though we invest in a time of diminished return expectations, astute investors can still profit by adjusting to the new environment. We offered some adaptive strategies.

Those managers who are slow adjusting their return targets downward complain of low deal volume while the more flexible and realistic managers are vigorously pursuing and closing transactions. Only lower return targets will clear the market.

GP capital may be rationed. Restricted GP capital impairs the ability to invest LP capital at market-clearing rates.

We likely have four to six years left of this recovery; this observation favors certain strategies, such as value-added and opportunistic investing with a three- to five-year horizon. Shorter investment horizons will be appropriate in those markets which are peaking early.

Investors should seek out non-traditional, but prudent, investments in collaboration with skilled operating partners. The fleet of foot and nimble will search out non-traditional strategies, such as secondary and tertiary cities, and mispriced niches in the capital stack. Others who remain rigid in their market outlook may languish.

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