DISTRESSED REAL ESTATE INVESTING

Private Markets Team

Executive Summary:

Overview: Unemployment, reduced consumer spending, tightened credit standards, and limited available debt have negatively impacted operating income and market price for most commercial properties. Additionally, the reduced valuations have limited the amount of debt which may be refinanced. Core and value-add real estate investment strategies face the headwinds of increasing vacancy rates, declining rents and increasing lessee defaults. The recent cyclical downturn in the commercial real estate market has created a distinct multi-year opportunity for specialists in distressed real estate. However, as the real estate cycle continues to decline, near term performance in the current environment is more influenced by the market conditions (beta or general macroeconomic themes) and less so by the manager's ability to impact property operations (or alpha).

The Great Deleveraging: The credit crisis of 2008-2009, and the ensuing economic recession, has put pressure on real estate investments. Specifically, the lack of credit available makes refinancing debt more challenging. The softer economy negatively affects property vacancies, which depresses the rental income stream. Because of the constrained debt financing environment and the downward pressure on income, real estate values have been significantly impaired, as much as 30-50% off of 2007 peak values, depending on the property.

Multiple Opportunities: The current distress in the real estate market, therefore, is two-fold, creating numerous opportunities for distressed specialists. First, the capital structure and financing challenges creates opportunities for investment managers skilled in debt trading, lending, restructuring, bankruptcy negotiations, and other capital-structure solutions. Second, the weakened economy has put stress on operating fundamentals such as vacancy, rental rates, etc. When the real estate cycle bottoms, and fundamental property analysis becomes more certain, the opportunity will emerge for real estate operating specialists who can turnaround a "broken" property as well as secondary real estate fund managers.

OPPORTUNITIES EXIST FOR THOSE WHO CAN PROVIDE LIQUIDITY TO ECONOMICALLY CHALLENGED INVESTMENTS.

Conclusion: NEPC believes that investors in real estate should focus on distressed and debt strategies. Due to the severe magnitude of the downturn, there will be a multi-year opportunity for both capital structure specialists as well as real estate operators. This recommendation is based upon where we are in the current real estate cycle which is currently characterized by deteriorating fundamentals. Investors in the near term should focus on capital structure driven distressed strategies as opposed to operator-centric (single property) focused models. As the market conditions begin to improve, the investment focus will broaden to include both real estate secon-

dary and distressed operator/turnaround strategies.

Ideally, a distressed specialist is both a skilled operator as well as a capital structure specialist. In reality, most investment managers have a stronger background in one area or another. What is most important, therefore, is that investment managers focus on their area of expertise, and avoid the temptation of "overreaching" into other areas where they have less experience.

THE REAL ESTATE CYCLES INCLUDE RECESSION, RECOVERY, EXPANSION AND CONTRACTION.

The Cyclicality of the Real Estate Market:

Just as the general economy is cyclical, so too is the real estate market. Throughout the current and prior times, real estate values mirror the general economy, rising in good times and falling in bad. However, the real estate cycle tends to be more volatile than that of the general economy – a characteristic when combined with significant leverage that makes investing in real estate potentially lucrative, but also very risky. If you time the cycle well, the profits can be significant; but if you time the cycle incorrectly, the losses can be just as large.

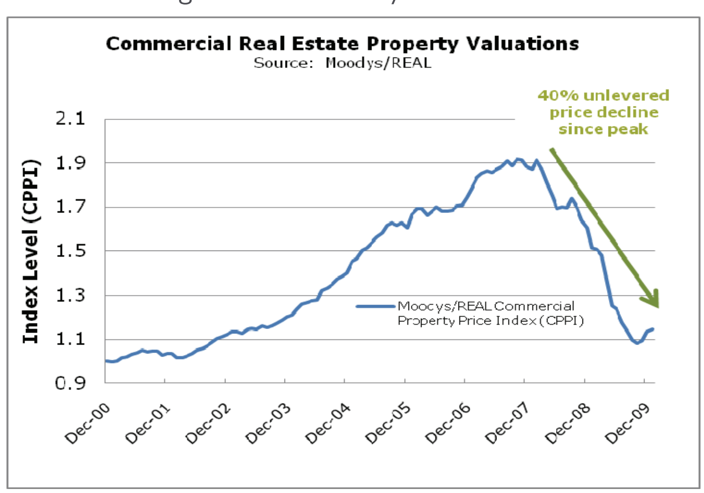
To recognize where you are in the real estate cycle, you have to define the real estate cycle. The real estate cycle has been commonly defined by various studies as having several phases; (1.) Recession; (2.) Recovery; (3.) Expansion; and (4.) Contraction. The real estate cycles are both macro (regional, national and international) and micro (property specific or metropolitan area). The real estate cycle provides varied opportunity at different points in the cycle.

One cause of the repeated boom and bust cycle is the delay between how quickly real estate demand and supply adjusts to improvements and declines in the overall general economy. In economic terms, demand for real estate is more elastic than supply.

When markets are rising, the demand for real estate reduces vacancy rates and increases rents. Real estate developers seek to capitalize on these trends, commencing new projects to create additional space to fulfill this demand. However, due to the time that it takes to renovate or construct properties, real estate supply often lags in its ability to fulfill demand.

As the general economy accelerates, so too does real estate demand, widening the gap between real estate supply and demand and accelerating the rise in real estate values. Sensing this separation in the market and the potential to capture gains from rapidly increasing valuations, new real estate development accelerates, often over projecting demand in an attempt to close the gap created by the delay in developing properties. Depending on the length of the cycle, many of these new developments will be very successful, capturing the favorable expansion of the cycle. However, the economic cycle invariably turns. Demand for real estate declines. While leases and other contracts have the ability to delay this response, predictably, the supply side of the equation is not able to respond as quickly, leading to falling rents, increasing vacancies and rapidly declining valuations.

While this boom and bust cycle is one that has repeated over time, what has made the current real estate cycle even more dramatic was the height of the peak and how quickly and severely the cycle turned downward. The following graph highlights the magnitude of the volatility in real estate values throughout this recent cycle, depicting the dramatic rise and fall of real estate values through the last seven years:



The extreme nature of these recently volatile conditions was largely caused by:

– Overleveraging of properties due to cheap available debt,

– Credit crisis that froze or reduced refinancing and eliminated new financing, &

– Subsequent economic downturn that put pressure on real estate fundamentals.

Whereas properties had previously been financed with 60% fixed-rate, whole loan debt, real estate transactions in 2004-2007 were characterized by complex capital structure financings (many tranches of senior debt, mezzanine, and equity), with much higher loan-to value ratios. The equity portion of properties with high loan-to-value ratios had little "cushion" to withstand downward pressure to values.

THE DOWNTURN IN REAL ESTATE HAS IMPACTED ARCHITECTS, ENGINEERS AND BUILDERS .

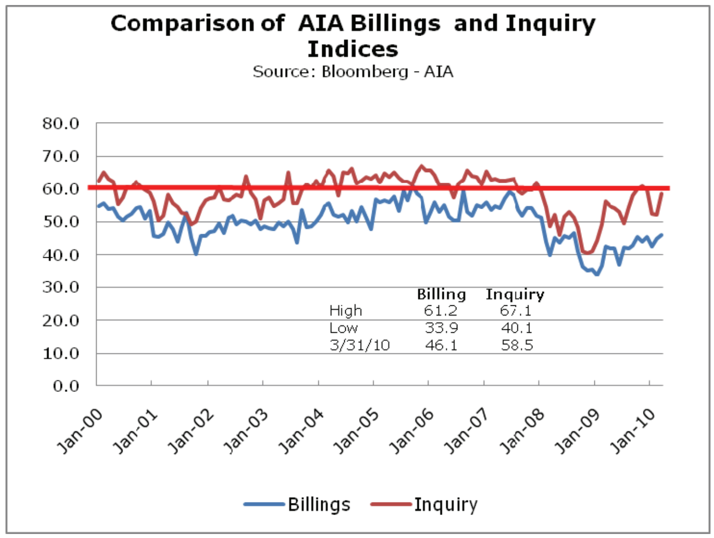
So where are we in the cycle? The answer depends on the private markets strategy, which side of the investment you are on, where your investment is in the capital structure and the economic drivers of the strategy.

The Current State of Real Estate – Where are We in the Cycle?

To determine our position in the cycle, we need to take a collective view on investors, designers, developers, builders, financers, buyers and lessees who comprise an interwoven network of real estate professionals.

Architectural Activity:

The demand for architectural services serves as a data point that is a leading indicator of the trend in the supply of real estate. The American Institute of Architects' recent survey highlighted the main issue impacting its membership is the inability of owners/developers to obtain construction financing for their respective projects. The respondents ranked the various types of projects where they have financing concerns: 71% of the respondents ranked commercial projects as their primary concern followed by new construction projects (68% of the respondents); and large projects (5 of the respondents). The survey respondents' also ranked financing as less of a concern for health care (10%); industrial (17%) and education (18%). The following chart compares the Architects' Billing (ARCHWOTB) and Inquiry (ARCHINQU) Indices. Historically, construction work lags the AIA Billing Index by six months. A recovery is indicated when the AIA Billings Index is consistently above 50, the index has been below 50 since January 2008 when the index was 51.1, indicating that we have not yet reached the bottom of the cycle.



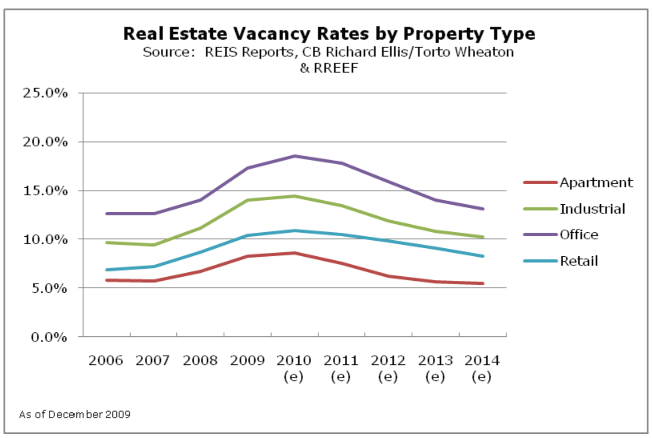
The lack of financing and projects has had a negative impact on real estate related businesses. Through December 2009, engineering and drafting firms lost 78,000 positions (8.2% of the total positions); architecture firms lost 51,000 positions (23%); interior design firms lost 12,000 positions (27.6%); landscape architecture firms lost 20,000 positions (40.1%) and construction has lost 2.1 million positions (27.2%). These statistics indicate that for the foreseeable future, there will be few new properties coming on line and tenant improvements are being tightly managed and scaled back.

Vacancy Rates:

CRESA Partners, a tenant representation firm, has reported office vacancy in the United States has reached 17.2% during the first quarter of 2010, the highest vacancy rate since 1994. The following chart from REIS Reports, CB Richard Ellis/Torto Wheaton and RREEF projects that vacancy rates will increase across all sectors in 2010, before starting a gradual decline in 2011 – a further indication that the cycle has not yet hit bottom.

THE RECESSION HAS DRIVEN VACANCY AND DELIQUENCY RATES TO HISTORIC HIGHS.

While vacancy rates continue to increase, effective rent was down 7.4% from a year ago, putting further pressure on a challenged sector. To maintain tenants, landlords are giving one- and two-year extensions on real estate leases with the expectation the market will improve by 2012. Lenders are extending loan repayments rather than writing down or writing off loans.



Delinquency Rates:

As property vacancy increases, operating cash flows will decrease and loan delinquencies will increase. Foresight Analytics, a unit of Trepp LLC, collected statistics that show construction loan delinquency rates at historic high levels across some of the construction segments. The following table summarizes the delinquency rates by the various construction loan property types.

Construction Loan Deliquency Rates
Foresight Analytics, a unit of Trepp LLC

Loan Types	Q4 2009
Condo Construction Sector	41.5%
Single Family Sector	27.3%
Construction Loans and Land Loans	18.6%
Apartment Construction	11.9%
Non-Residential Commericial Construction Loans	11.1%

The FDIC tracks loan delinquency for banks across a broader range than just construction loans. Its data includes delinquencies on mortgages on residential properties, commercial and industrial loans, real estate business loans, real estate construction loans and others. While its data show real estate construction loan delinquencies declined by 2.7% in Q4 2009, the FDIC aggregate portrays an increase of 6.6% on average for all bank real estate related loans in Q4 2009, including a 14.9% increase in the number of residential delinquencies and a 12.2% increase in real estate business loan delinquencies for the quarter.

Growth In Non-Current Loans & Leases
90 Days or More Past Dues or In Nonaccrual
Source: FDIC Quarterly Report

Loan Type	Increase in Non-Current Loans and Leases Over the Previous Quarter $ in billions	% of Total
Residential Mortgages	$23.2	14.9%
Commercial & Industrial (C&I)	($3.5)	(7.7%)
Real Estate - Construction	($2.0)	(2.7%)
Real Estate - Business	$4.5	12.2%
Other	$2.2	
Increase for the Quarter	**$24.4**	**6.6%**
Total for the Year	**$391.3**	

Future Debt Maturities:

The options are limited for both property owners and lenders, as property values continue to decline, loans mature, refinancing is not readily available and property sales are minimal. Foresight Analytics has projected $1.4 trillion of commercial real estate loans are coming due between 2010 and 2014. Of the amount coming due, approximately $869 billion of the maturing loans exceeds

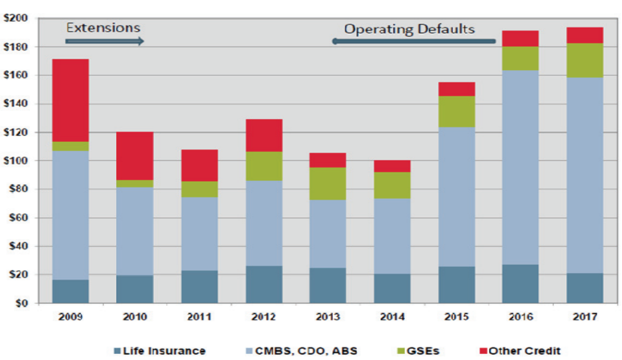
Projected Commercial Mortgages Maturities and Holders of the Mortgages
Source: Foresight Analytics, a unit of Trepp LLC
($ in billions)

Year of Maturity	Mortgages Exceeding Property Values $	% of Total	Total	Lender Types Banks	CMBS	Life Cos.	Other
2010	$96	35.6%	$270	$153	$46	$18	$53
2011	$144	48.5%	$297	$166	$56	$18	$57
2012	$193	63.1%	$306	$172	$55	$19	$60
2013	$184	60.5%	$304	$163	$64	$20	$57
2014	$252	94.7%	$266	$130	$67	$19	$50
Totals	**$869**	**60.2%**	**$1,443**	**$784**	**$288**	**$94**	**$277**

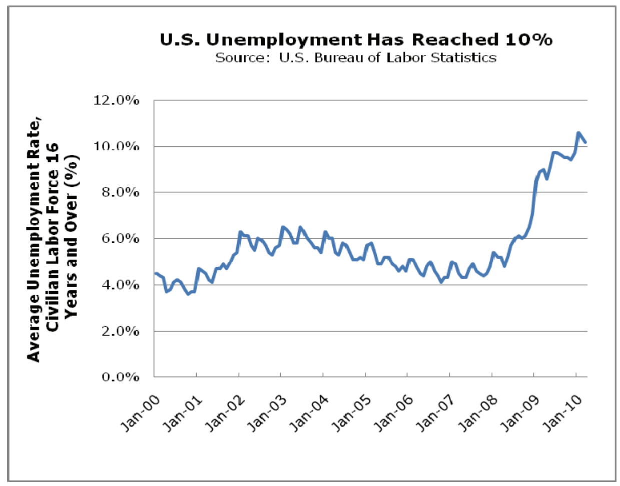
the current property value. The above table projects the amount of underwater loans maturing during 2010-2014 and the respective holders of these loans.

While these near term repayments are significant, particularly in light of how many properties are valued underwater, debt maturities expand significantly in 2015 beyond the 2010-2014 levels. The following chart, from AEW and the Mortgage Bankers Association, shows how the volume of non-bank real estate related debt maturities is currently scheduled to increase from $100 billion in 2014 to $150 billion in 2015 and nearly $200 billion in 2016 and 2017.

Non-Bank Commercial Mortgage Maturities
Source: AEW, Mortgage Bankers Association
($ in billions)



For the fourth quarter of 2009, CRE Finance Council and Trepp reported the CMBS default rates for both the office (3.31%) and multi-family (8.24%) sectors are at the highest points in the last ten years. Fitch Ratings is forecasting CMBS defaults to exceed 11% by the end of 2010 and expects the majority of defaults will come from the 2006-2008 vintage years, when $445 billion was issued. From a delinquency and default perspective, the current conditions for real estate owners are not good – and with the looming wall of debt maturities rapidly approaching, many will face the daunting task of trying to refinance to extend their payments or risk losing all of their equity to creditors.



Residential Real Estate:

While commercial real estate continues to decline, the residential real estate market is showing some signs of stabilizing, as existing home sales are up, residential construction has stopped falling, and inventories are down. However, this situation can change quickly. For a recovery to occur in the housing market, unemployment needs to decrease, while home prices and mortgages need to remain affordable and available. Current unemployment data, as reflected in the above table, do not yet support the start of the recovery with unemployment rates near 10% and projected to rise in the near term.

The residential market has risks including the withdrawal of the government's support and the expiration of tax credits. The Federal Reserve and the U.S. Treasury's purchases of agency MBS ($1.11 trillion representing 65% of the $1.71 trillion issued during 2009) has helped maintain life in the market, yet the withdrawal of these pillars of support raises risk in the segment. Further, the FHA and the VA guaranteed 24% of the mortgage originations for the first nine months of 2009. This is a staggering increase relative to 2006 when both agencies guaranteed 2.7% of the mortgages. The Government Sponsored Entities, GSE's, have increased their conforming loan limits and mortgage limits which increased the availability for home purchases in higher priced areas.

THE REAL ESTATE DOWNTURN HAS SPILLED OVER TO THE BANKING SECTOR.

An uptick in the pace of foreclosures also poses a risk to the residential market and will increase the pending supply or *"shadow inventory."* At Q3 2009, the shadow inventory was estimated at 1.7 million units. As the banks address their real estate related losses, they will continue to tighten their credit standards for residential loans.

Fourth Quarter 2009 Net Charge Offs (NCOs)
Source: FDIC Quarterly Report

Loan Type	Increase in NCOs Over the Previous Quarter $ in billions	% of Total
Residential Mortgages	$3.3	47.7%
Credit Cards	$2.7	41.4%
Commercial & Industrial (C&I)	$2.3	37.0%
Home Equity Loans	$1.9	58.6%
Real Estate - Business	$1.9	130.9%
Other	$2.3	
Increase for the Quarter	**$14.4**	**37.2%**
Total for the Quarter	**$53.0**	

The Banking Industry and Real Estate:

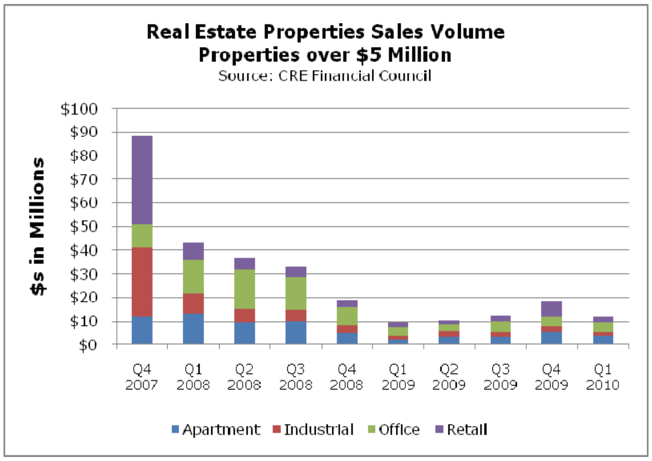
The Financial Industry continues to suffer from the aftershocks of the declining real estate market. The impact has been acute for Banks. The FDIC reported that the banks' Net Charge Offs (NCOs) totaled $53.0 billion for the 4th quarter 2009, a $14.4 billion or 37.2% increase over the 4th quarter 2008. The 4th quarter 2009 is the highest quarterly charge off for the last 26 years for which the NCO data is available. The 4th quarter of 2009 is also the 12th consecutive quarter that NCOs posted an increase over the prior quarter. The above table summarizes the NCOs and the growth in Non-current Loans.

At December 31, 2009 the FDIC identified 702 banks with $402.8 billion of total assets for their *"Problem List,"* the highest level for both the number of institutions and assets since June 30, 1993. This is a significant increase over the year ended December 31, 2008 when the FDIC's *"Problem List"* had 252 banks with $159 billion of assets. The FDIC closed 140 insured institutions during 2009, and has closed 57 insured institutions during 2010 (January 1 – April 23). The current trend in bank failures is significant when compared to the 148 banks that failed during the 16 years ended December 31, 2008. Because the banking and real estate industries are so closely intertwined, there exists the potential risk that increases in bank failures that lead to further destabilization of the U.S. banking industry will send a shock wave through the real estate markets resulting in tighter credit, valuation declines and a prolonged time to achieve recovery.

Real Estate Transaction Volume:

Real estate investors have suffered through the dramatic decline in the market in the past three years. Transaction volume has decreased significantly as both the credit markets and the real estate markets struggled to properly assess property risk and valuations. Many investors are "stuck" with properties they do not want, or cannot refinance, due to the lack of credit available. The chart on the following page shows a dramatic reduction of levels of transaction volumes in the past two years.

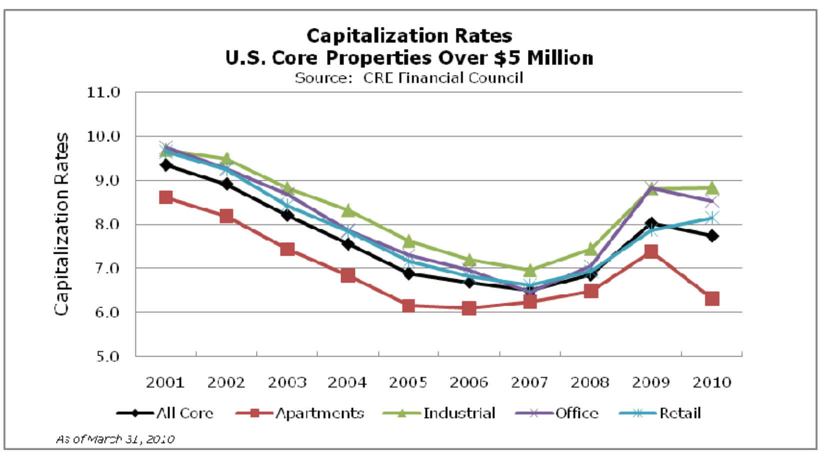
While credit markets have appeared to reopen in 2009, enabling transaction volume to rise to nearly $20 billion in Q4 2009, uncertainty in the global economies and credit markets make this a tenuous sign of improvement in the real estate market.



REAL ESTATE SALES VOLUMES ARE DOWN; CAP RATES HAVE RISEN BUT NOT TO HISTORIC HIGHS.

Real Estate Cap Rates:

Real estate capitalization rates (the property income divided by the price) fell to cyclical lows in 2005-2006, and have increased through 2009. However cap rates for all categories have not yet increased to the level of 2001, which marked the trough of the last real estate cycle. This highlights the potential for further valuation declines in the real estate market in the year or years to come.



So to summarize where we are, while the declines in the real estate market over the past three years have been significant, most of the data seem to indicate that there are still declines ahead. With persistent global economic uncertainty and increasing concerns regarding the effect of European country debt defaults on the markets, it is difficult to predict if the real estate market is close to hitting bottom and starting a stable and measured recovery.

The Distressed Real Estate Investment Opportunity:

Distressed Opportunity Characteristics:

In today's market, most real estate properties exhibit a number of types of distress (often properties will exhibit more than one type of distress), some of which are listed below:

Unrelated/Macro Distress – micro-level property investments can be affected by general macroeconomic distress including: capital markets (credit crisis can temporarily cause stress to investments), political (changes in policy, political leadership) or environmental / physical (storms, terrorism, etc.).

Capital structure distress – the value of the asset has declined below the debt balance, and the current equity holder is out of the money. The property could be defaulting on the loan (either in regards to maturity or payment default), or could be in foreclosure process with the senior lender.

Organizational distress – there is some conflict or dispute among the various parties, including: organizational/staff issues (departures), legal disputes, or organizational dysfunction / misalignment of incentives among various parties.

Property distress – property managers have neglected the physical property, typically due to lack of investment or capital expenditure or due to a poor execution of strategy relating to leasing or repositioning.

Depending on the situation, there can be a "downward spiral effect," where a capital markets shock can cause capital structure distress, followed by property distress and organizational distress. Distressed specialists must be able to underwrite and understand many elements of potential distress that can affect a real estate property.

Distressed Investment Strategy Definitions:

Real estate distressed managers have multiple investment opportunities, including purchasing debt packages at a discount from motivated sellers; purchasing unfinished projects; and purchasing portfolios from distressed real estate owners who are seeking financial relief. Distressed managers are mostly focused on the office sector followed by the multi-family sector because of the number of opportunities in each category.

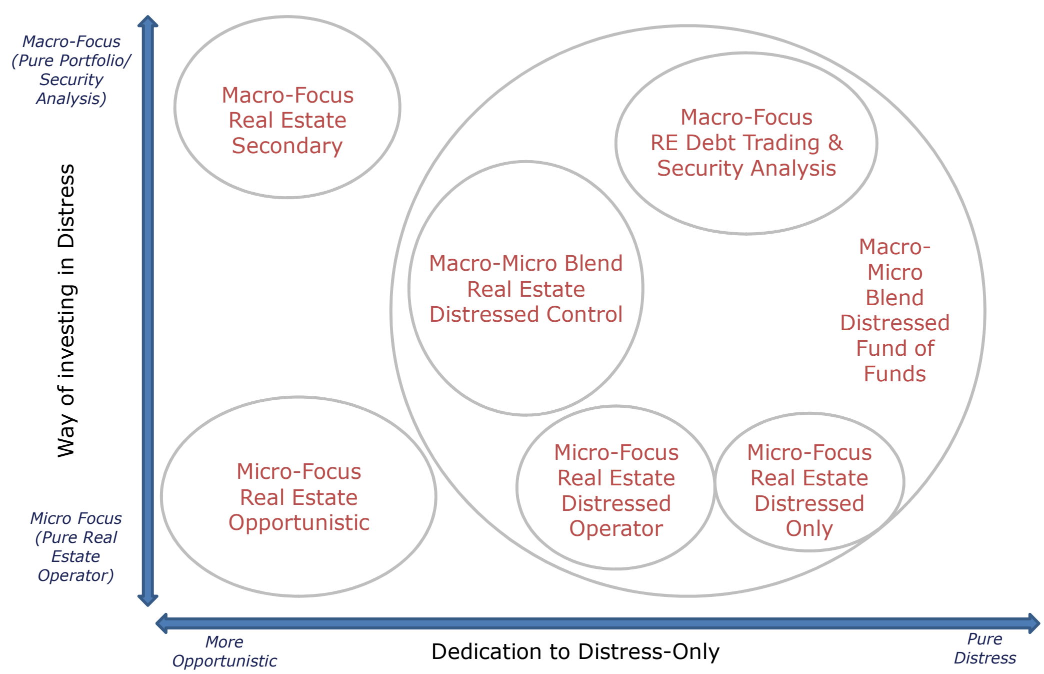
STRATEGIES PERFORM DIFFERENTLY DEPENDING ON THE PHASE OF THE REAL ESTATE CYCLE.

Real estate distressed managers may try to employ a variety of strategies to take advantage of the current market. While some specialize in one strategy, others tend to use many different strategies, depending upon the opportunity. The manager names listed under the strategies are representative, and a manager may be listed under multiple strategies. The strategies are categorized between macro and micro focuses (security analysis and control versus real estate operator) and opportunistic versus pure distress strategies. Finally, fund of funds tend to invest in a number of different strategies.

As a general rule, most of the distressed-focused real estate strategies will be investing in the senior tranches of the capital structure, given the more attractive risk/return profile of the debt position. The strategies differentiate themselves by how the debt securities are underwritten. Some focus on buying or issuing performing, high-yielding debt with the intention of holding the instrument to maturity or selling to another buyer (non-control). Others expect to buy or issue the "fulcrum" security that gives control to the manager; buying existing real estate debt with the expectation of foreclosing and owning the property at an attractive level. The first strategy relies more heavily upon security and portfolio analysis, whereas the second strategy focuses more on operating and restructuring capabilities.

The diagram that follows is a schematic that shows examples of managers investing in distressed real estate, along the spectrum from opportunistic to pure distress, and from micro- to macro-focus.

Defining the Distressed Real Estate Landscape



Macro-Focus -- Real Estate Debt Trading / Security Analysis Strategy (no control):

This strategy takes advantage of technical dislocations in the market that other market participants do not understand. For example, a manager might purchase General Growth debt, with the anticipation that the price of the debt will rise once the bankruptcy has completed. Another non-control strategy might focus on issuing real estate whole loans to finance a property, with the assumption that the property will continue to service the debt payments. This strategy does not tend to rely upon real estate operating expertise, and a manager employing this strategy does not look to take control of a company or property ("loan-to-own"). Not only is this strategy employed by private equity-structured managers, this is also employed by hedge fund-structured managers as well, given the shorter timeframe and potentially higher liquidity of the security.

OPPORTUNITIES EXIST FOR MACRO, MICRO AND BLENDED DISTRESSED STRATEGIES.

Macro-Focus -- Real Estate Secondary Fund Strategy (no control):

This strategy takes advantage of distress within the market and with the limited partners who invest in comingled real estate funds. Secondary real estate managers seek to find distressed sellers of LP interests in comingled funds. Typically they target comingled funds that are nearly fully invested in order to maximize their ability to underwrite the value of each property within the targeted funds. This strategy is one that is followed by a limited number of investment groups.

Macro-Micro Blend -- Real Estate Distressed Control Strategy:

This strategy focuses on organizational distress, and requires some operational expertise. In this strategy, the manager buys the position in the capital stack where the control lies (or will soon be located). This strategy might include bankruptcy and foreclosure situations. Compared with the operator strategy listed below, this strategy might focus on investing at the company level rather than at the property level. This strategy tends to have less current income than the non-control strategy, and therefore, has a higher risk/return profile. Many managers employ both a control and non-control strategy, depending on the specific investment opportunity.

Macro-Micro Blend -- Distressed Real Estate Fund of Funds Strategy:

Some fund of funds offer a specific distressed real estate fund of funds. These fund of funds typically invest in a number of underlying strategies and managers, including those pursuing a more micro- or macro-focused strategy. This strategy might be attractive to a smaller investor looking to increase diversification, who was able to tolerate the higher fees that are incurred with a fund of funds.

Micro-Focus -- Real Estate Distressed Operator Strategy:

This strategy requires significant real estate operating expertise, and tends to be employed on a smaller scale that of the security analysis strategy. Managers following this strategy have significant in-house asset management and property management resources. The manager may invest in a senior security of the property, but expects that, due to distress, this will be the control security, and that the manager will take control of the property. These managers have experience with leasing, repositioning, and restructuring properties. Depending on the position in the capital structure, an investment may have some current income, or might rely upon capital appreciation upon emerging from the distressed situation (foreclosure, etc.).

Micro-Focus -- Real Estate Opportunistic Strategy:

This strategy, as the name implies, is not dedicated to distress, but instead "times the market" depending on the current environment. In growth environments, this strategy focuses on repositioning or ground-up development strategies. In distressed environments, the strategy returns to investing in distressed-focused situations. Because of this strategy's flexibility, the manager tends to invest in up- and down-markets.

Some traditionally opportunistic managers are now currently raising distressed debt-only funds rather than broad opportunistic funds.

Micro Focus -- Real Estate Distressed Only Strategy:

This type of manager tends to not have a complementary investing strategy in up-markets, and does not typically pursue development or repositioning opportunities. The manager has a smaller opportunity set during growth markets, and may not invest as much money during these periods.

NEAR TERM INVESTMENT FOCUS SHOULD BE ON DISTRESSED DRIVEN STRATEGIES.

Portfolio Construction:

Real estate distressed opportunities should be included in a private real estate program. These investment strategies provide; (i) strategy diversification to the real estate program; (ii) potentially reduce risk via the use of debt securities, which offer downside protection to default by residing higher in the capital structure, and (iii) low correlation to the equity markets and other alternative asset classes.

Investors with sufficient staff, a large asset base and a flexible governance structure should consider constructing a diversified portfolio of partnership interests that provides exposure to distressed strategies. Investors who are more resource constrained or have smaller asset bases should consider the diversification benefits of building distressed exposure through a fund of funds vehicle.

As the real estate cycle turns, investors with the ability to build out a distressed real estate allocation should consider allocating a portion of the portfolio to a real estate operator specialist as well as a manager with more portfolio/security analysis expertise.

Portfolio Structure:

In making a recommendation for including a distressed real estate allocation, we consider the need to mitigate manager, strategy and vintage year risk associated with the real estate program. These risks are addressed by appropriately sizing the commitment to each manager, pursuing a diversified allocation effort and by committing to an investing program over a multi-year period.

Portfolio company risk can be addressed by investing in managers that build well diversified portfolios or investing in multiple managers with different target markets. When compared to other strategies in a private equity portfolio, the distressed real estate opportunities strategy (especially the debt/trading focus) is expected to generate distributions within a shorter time period either through a manager's trading strategy or a rapid restructuring. Managers will typically exit their positions within 24-36 months. Managers who pursue an operator-focused strategy may require a longer period of time.

Geographic Focus:

Some of the managers highlighted in this market survey can be considered global investors, with investments in North America, Europe, Asia, and Emerging Markets regions. Others tend to have a more region-specific focus. Given the depth and breadth of distress in the US (and European) real estate markets (as opposed to the relative strength in Asia), most distressed strategies will focus on the developed markets, in particular, the United States.

Strategy Risks:

Distressed real estate managers will most likely have an attractive multi-year opportunity set in which to invest. However, due to the extent of the distress in the real estate market, a distressed real estate strategy risks timing the market opportunity too early. In addition, an investment manager may underestimate the length and depth of the real estate distressed market, and invest in strategies that rely upon a swifter recovery.

Conclusion – Patience and a Disciplined Process during this Multi-Year Investment Opportunity:

The current opportunity set in distressed real estate is derived from a number of specific issues: the overvaluations caused by overleveraging of properties due to cheap available debt, the credit crisis that froze or reduced refinancing or new financing, and the subsequent economic downturn that put pressure on real estate fundamentals.

NEPC ADVISES A DISCIPLINED PROCESS THROUGH A MULTI-YEAR DISRESSED REAL ESTATE CYCLE.

Because of the depth of the value declines, the lack of available financing, and the weakening of real estate fundamentals, the distressed real estate opportunity will persist over a number of years. In addition, because of the many sources of distress facing real estate properties, a variety of distressed strategies will be more or less attractive during this multi-year opportunity.

Real estate investments favor debt and distressed focused funds during this current bottoming part of the cycle. Investors recognize the current market conditions are conducive to debt and distressed strategies as property underperformance persists and equity valuations remain highly uncertain. Currently, debt and distressed investments are expected to outperform equity real estate investments. Banks, the traditional lenders to real estate, have limited capacity to lend or have exited the market, which in turn has created an opportunity for real estate debt focused funds. Another source of debt is the CMBS market. During Q1 2010 $2.4 billion of CMBS was issued, which is well below the $61.2 billion issued during Q1 2007.

Investors in the near term should focus on capital structure driven distressed strategies as opposed to turnaround operator (single property) focused models as deteriorating fundamentals make underwriting efforts less certain and filled with risk. Recovery of the real estate market will rely upon growth of the general economy: first through GDP growth, then through gains in the employment rate. Only after these two metrics have shown signs of improving will tenants increase demand for real estate, which will improve real estate fundamentals and valuations. These metrics will signal the turn in the market cycle and a time to shift toward distress for control and other operator-centric strategies, in addition to secondary real estate funds.

Some economists believe that the economy will experience a "U" shaped recovery, with a long, multi-year recessionary trough. Others believe the economy risks experiencing a "double dip," where gains in economic growth will be reversed before an ultimate recovery. Some optimists see signs of recovery already in the economy – they point to stabilizing core commercial real estate prices, and even increase values in some instances. However, those who are less optimistic point to the European sovereign debt concerns and a wildly volatile stock market as indications that any recent improvements may be temporary and that further difficult economic time lie ahead.

Regardless of the ultimate timing and shape of the economic recovery, the distress in the real estate sector will most likely require years – rather than months – for successful workouts. Thus, investors which exhibit patience and prudence will ultimately be rewarded over the course of this distressed cycle.