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Credit Crunch Creates Challenges and Opportunities for Real Estate PE Funds

Funds' sizeable war chests may allow them to exploit lower prices

NEW YORK, 11 OCTOBER 2007 – Out of the turmoil of the credit crisis, many real estate private equity funds see new opportunities to deploy capital into a market with diminished liquidity, according to a new survey of the US institutional real estate private equity sector released today by Ernst & Young.

Gary Koster, Americas Leader for Ernst & Young Real Estate Fund Services, said that real estate fund sponsors participating in the survey, representing more than 285 investment funds, raised in excess of US\$23.5 billion in the first six months of 2007. Another US\$35 billion was planned to be raised by new funds that were being formed at the time of the survey. So the total capital raised in 2007 could exceed the US\$38.7 billion raised in 2006 by the survey respondents. Koster cautioned, however, that the shifts in the world's capital markets increase the likelihood that some portion of this fundraising will be deferred.

Koster said that it is clear that real estate private equity funds have been the dominant players on the real estate transaction landscape. Regardless of how the third- and fourth-quarter figures pan out, said Koster, the huge amount of capital raised in the first half of 2007 has already positioned funds with a very sizeable war-chest with which to seek out and acquire new assets over the next 12 to 18 months. "This summer's correction in the credit markets," he observes, "has significantly tightened lending activity and slowed transaction velocity. While this provides some challenges for sponsors in financing transactions, it also provides a window of opportunity for them to use their existing capital to exploit pricing opportunities created by market uncertainty."

Koster went on to add that even prior to the recent turmoil in the debt markets, the majority of survey respondents expected cap rate expansion, meaning lower pricing for many commercial transactions. "Debt market conditions just drive that point home," he said.

Hospitality and infrastructure gaining momentum

According to survey respondents, the four basic real estate asset classes – office, retail, multifamily and industrial – continue to attract the lion's share of fund capital. However, this year's survey shows that other asset classes such as hospitality and infrastructure have gained momentum. "More than 75% of respondents indicated that they believe the opportunistic return potential for infrastructure investments is 'fair or better' in today's market," said Koster, "indicating that more large institutional investors may allocate funds for the sector in the near future. The search for higher risk-adjusted returns has led sponsors to investigate new asset classes and geographic locations," Koster said.

In addition to the United States, respondents identified India and China as markets that have the greatest potential for higher risk-adjusted returns. Fund sponsors in countries like Australia, Germany, Japan, the United Kingdom, Luxembourg and the Netherlands are also becoming more innovative and global in their efforts to find attractive investment yields for their funds, according to the report.

Proposed US tax changes ‘top of mind’

“Also top of mind in the industry,” Koster said “is the proposed legislation in Congress which would increase the taxation of a fund sponsor’s ‘carried interest’ (the disproportionate allocation of fund profits to a sponsor after investors have received a specified return). If enacted, this proposal could greatly reduce the after-tax earnings of fund sponsors with a trickle-down effect to the fund sponsor management team. This is shaping up to be one of the most highly debated tax proposals in years.”

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Notes to editors:

About the report

Market Outlook-Trends in the Real Estate Private Equity Industry is the fourth in Ernst & Young’s series of surveys on the sector. In addition to Ernst & Young’s observations on the survey results, the report includes historical data on the growth of the private real estate fund sector gathered by the firm since 2001. This year’s report also includes perspectives on fund activity in markets such as Luxembourg, Japan, Germany, Australia, China, India, the UK and the Netherlands. To download a copy of the report visit: www.ey.com/realestate

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