US Private Real Estate Equity
Where do we go from here?

July 2009

BLACKROCK

Introduction

The current economic downturn, while slow in reaching the US and global real estate markets due to the lagged nature of the asset class, is the worst in over 50 years. It is the result of a series of negative events, the magnitude of which is expected to leave a lasting impact on the way business is done. Furthermore, through a Darwinian evolution, it has the potential to severely handicap the investment managers with whom investors do business. For such investors, there is the painful reminder that this downturn has transformed the conventional wisdom of real estate investing from "location, location, location" to its true core dimensions: "location, pricing, timing, and sponsorship".

This report is intended to provide a framework to help the reader understand the determinants affecting the real estate market today and to gain a better understanding of what direction it is moving from here. While material value declines are already underway and are expected to continue for at least the next several quarters, investors should be positioning themselves now to take advantage of what is potentially the greatest market opportunity in recent times.

Background

The modern era for institutional real estate investing began in the early 1990s. The public markets for real estate equity and debt emerged in the aftermath of the late 1980s and early 1990s downturn, allowing private real estate equity to become much more aligned with the broader capital markets. With a legion of Wall Street analysts following the industry, and an influx of superior information that could be used to price risk, real estate earned its recognition as a separate asset class alongside fixed income and equity.

In response to the early 1990s downturn and the ensuing savings and loan (S&L) crisis, the Resolution Trust Corporation (RTC), a US government-owned asset management company charged with liquidating assets of insolvent S&Ls, turned to securitization as a means to unwind "bad" assets. While different forms of securitization date back to 1970 when GNMA created the model for a pass-through mortgage-backed security, the form that was created by the RTC, tranched credit-rated securitization, was the same vehicle that was used to market the subprime and Alt-A mortgages. It was the issuance of these mortgages that drove home ownership to historic levels as depicted in Figures 1 and 2 on the following page.

Low credit quality loans were combined with other securities through the securitization process and sold to institutional portfolios around the globe. Once these securities became part of larger portfolios and the US housing market began to collapse (Figure 3), the value of the securities plummeted, resulting in a global re-pricing of risk, massive deleveraging, and the withdrawal of credit availability. Investor uncertainty and negative sentiment brought increased fragility to the financial system.

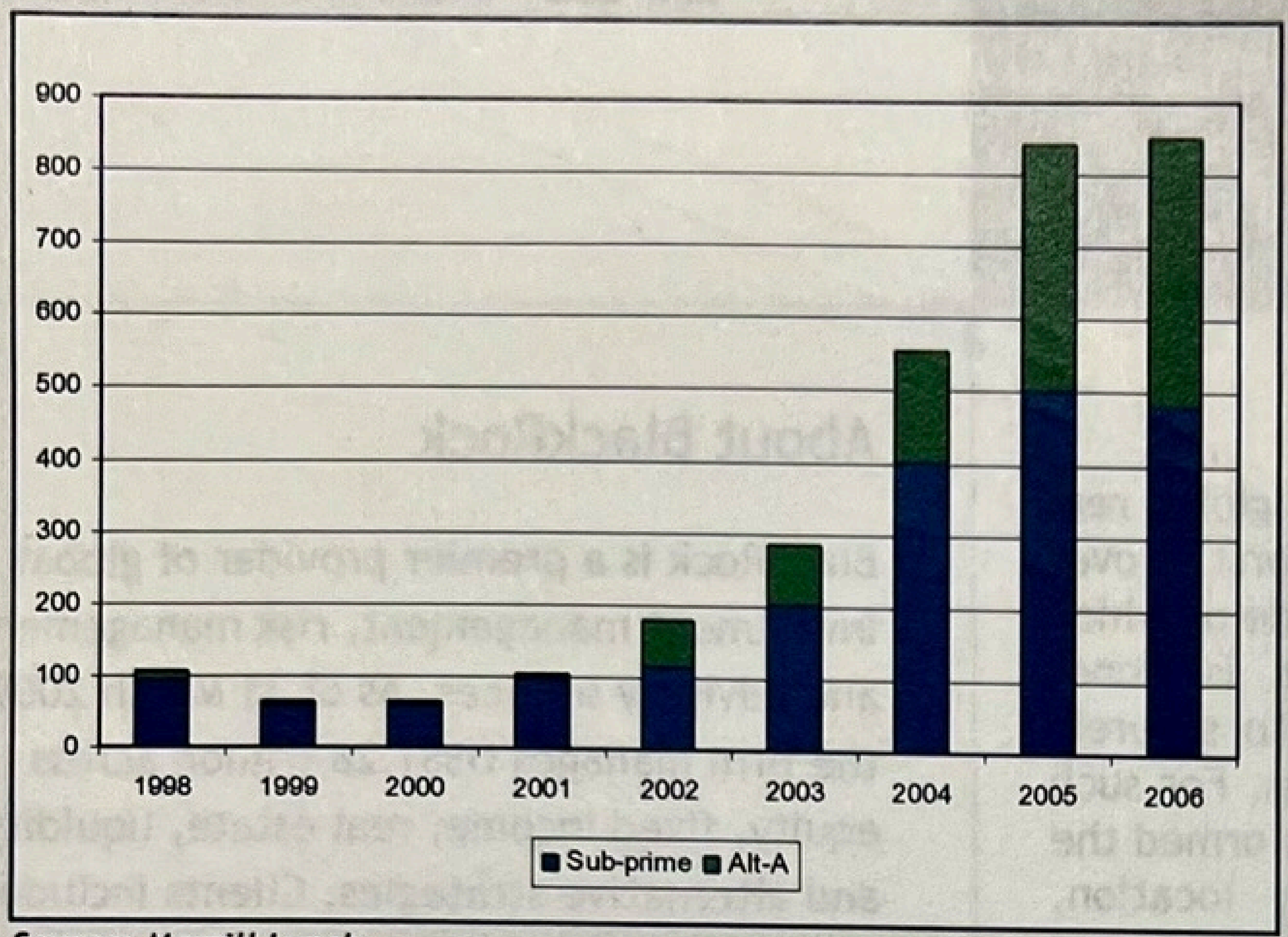
About BlackRock

BlackRock is a premier provider of global investment management, risk management, and advisory services. As of 31 March 2009, the firm manages US$1.28 trillion across equity, fixed income, real estate, liquidity, and alternative strategies. Clients include corporate, public, and union pension plans, insurance companies, mutual funds, endowments, foundations, charities, corporations, official institutions, and individuals worldwide.

Through BlackRock Solutions®, the firm offers risk management and advisory services that combine capital markets expertise with proprietarily-developed systems and technology. BlackRock Solutions provides risk management and enterprise investment services for US$7 trillion in assets.

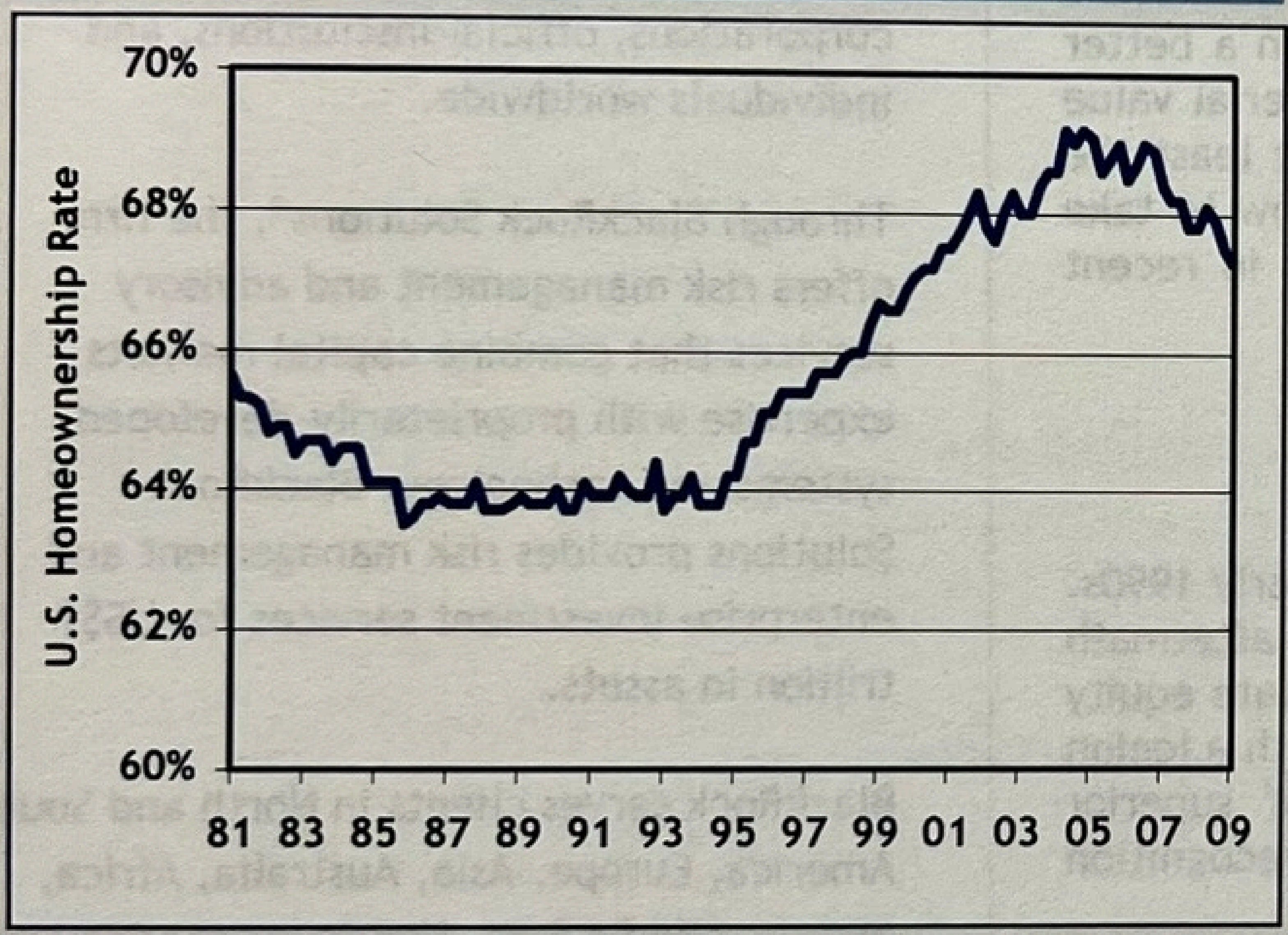
BlackRock serves clients in North and South America, Europe, Asia, Australia, Africa, and the Middle East. Headquartered in New York, the firm maintains offices in 21 countries around the world.

Figure 1. Gross New Issuance for Subprime and Alt-A ($bln)



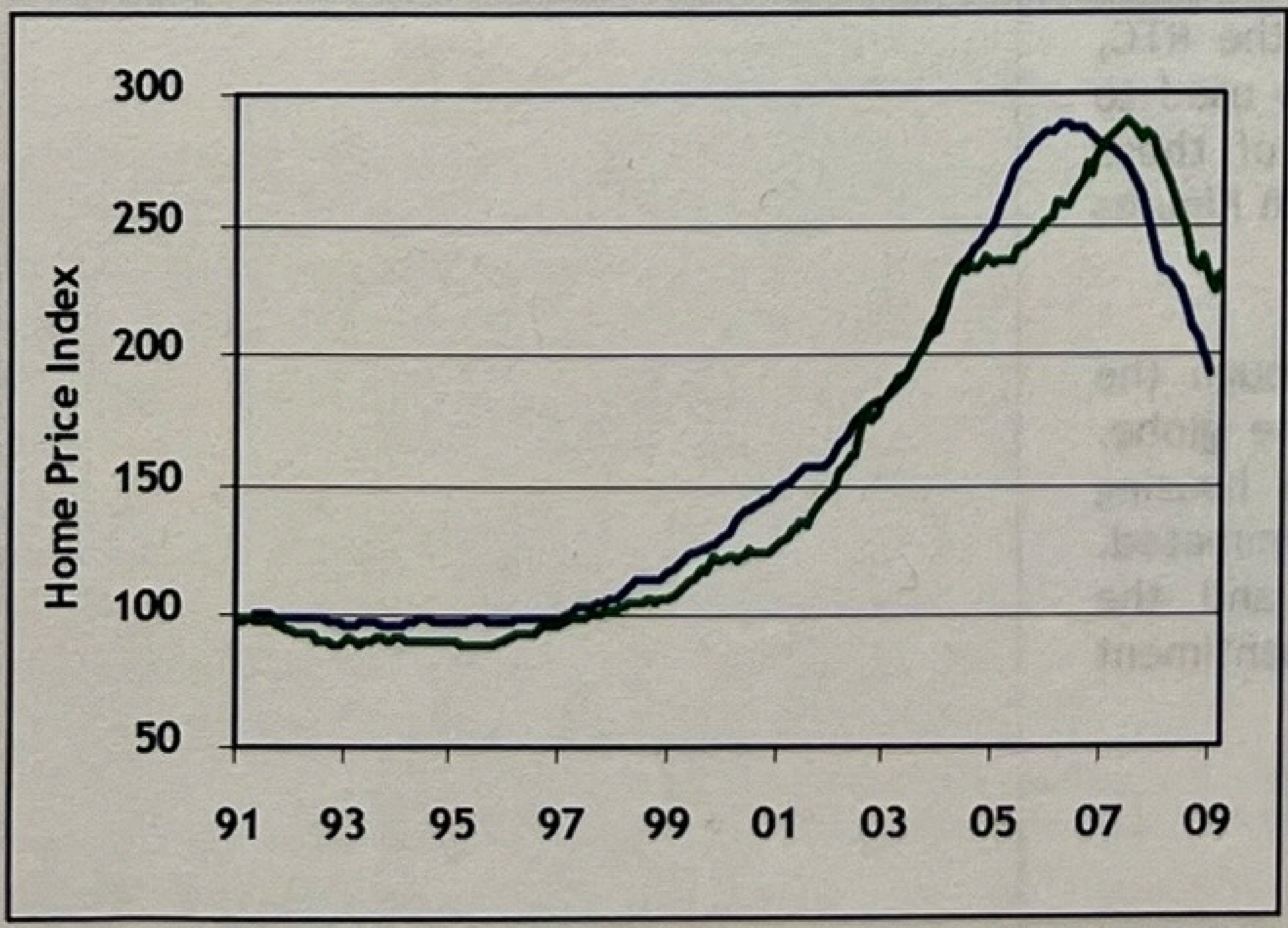
Source: Merrill Lynch

Figure 2. US Homeownership Rate



As of 31 March 2009
Source: U.S. Census Bureau, Housing and Household Economic Statistics

Figure 3. Re-pricing Started with U.S. Home Prices in 2006



Source: U.S. data from S&P Case Shiller 10-city composite as of 31 March 2009; U.K. data from Halifax as of 30 May 2009

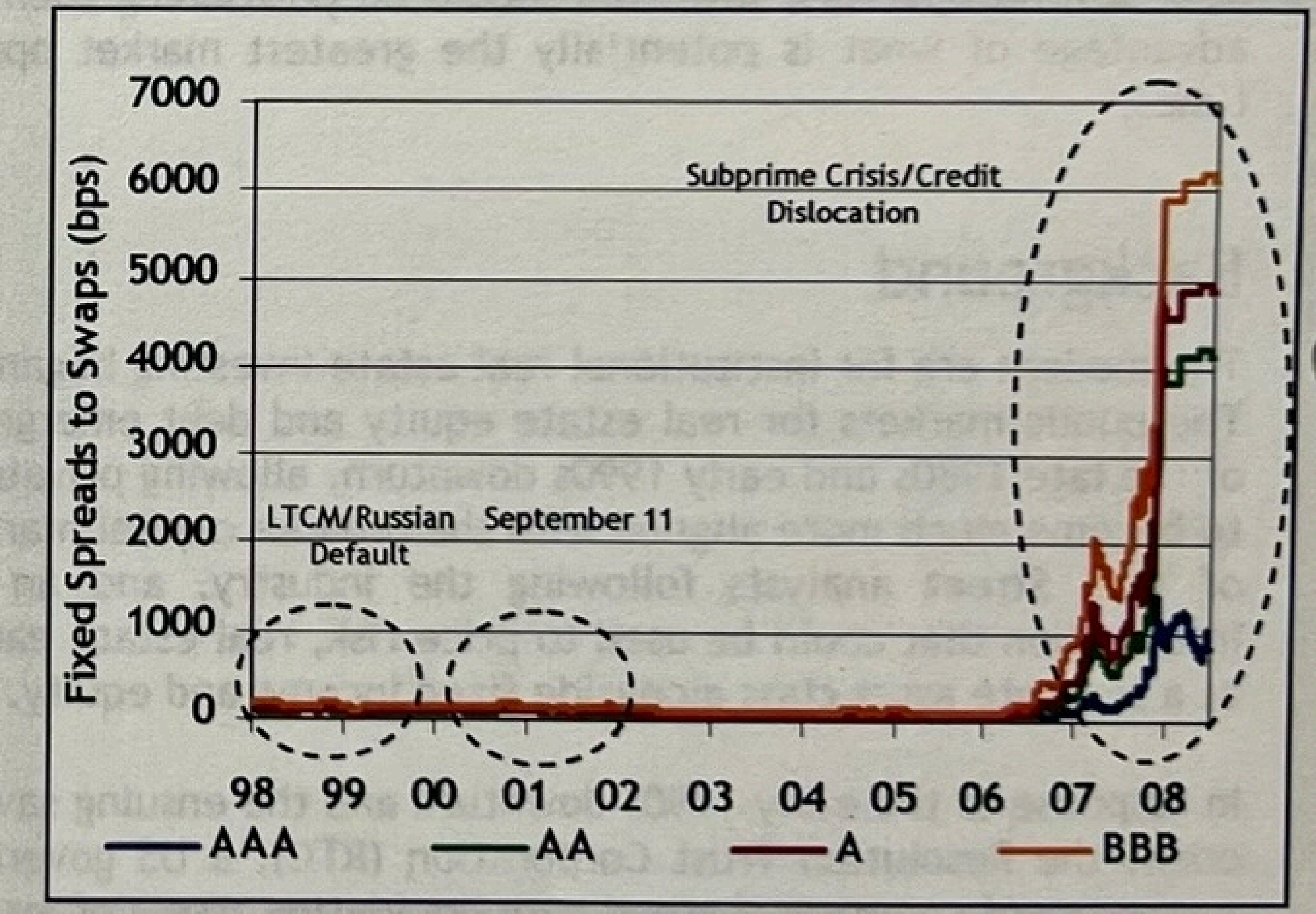
The Repricing of Risk

As the financing markets retracted in response to the recent capital market turmoil, risk premiums across all asset class expanded into uncharted territory. Even the Russian currency crisis in the late 1990s, which precipitated the demise of the hedge fund Long-Term Capital Management, and the market decline following terrorist attacks of September 11, 2001, barely altered the global financial landscape compared to the effects of the subprime debacle as depicted in Figure 4.

CMBS issuance virtually shut down in 2008 as loan issuance decreased to a trickle (Figure 5). Lenders became extremely risk averse and even borrowers with AAA credit found it difficult to secure financing. When they did, lenders were much more restrictive in the terms they were offering: tighter covenants, higher rates, more borrower equity required on refinancing, and no more interest-only loans.

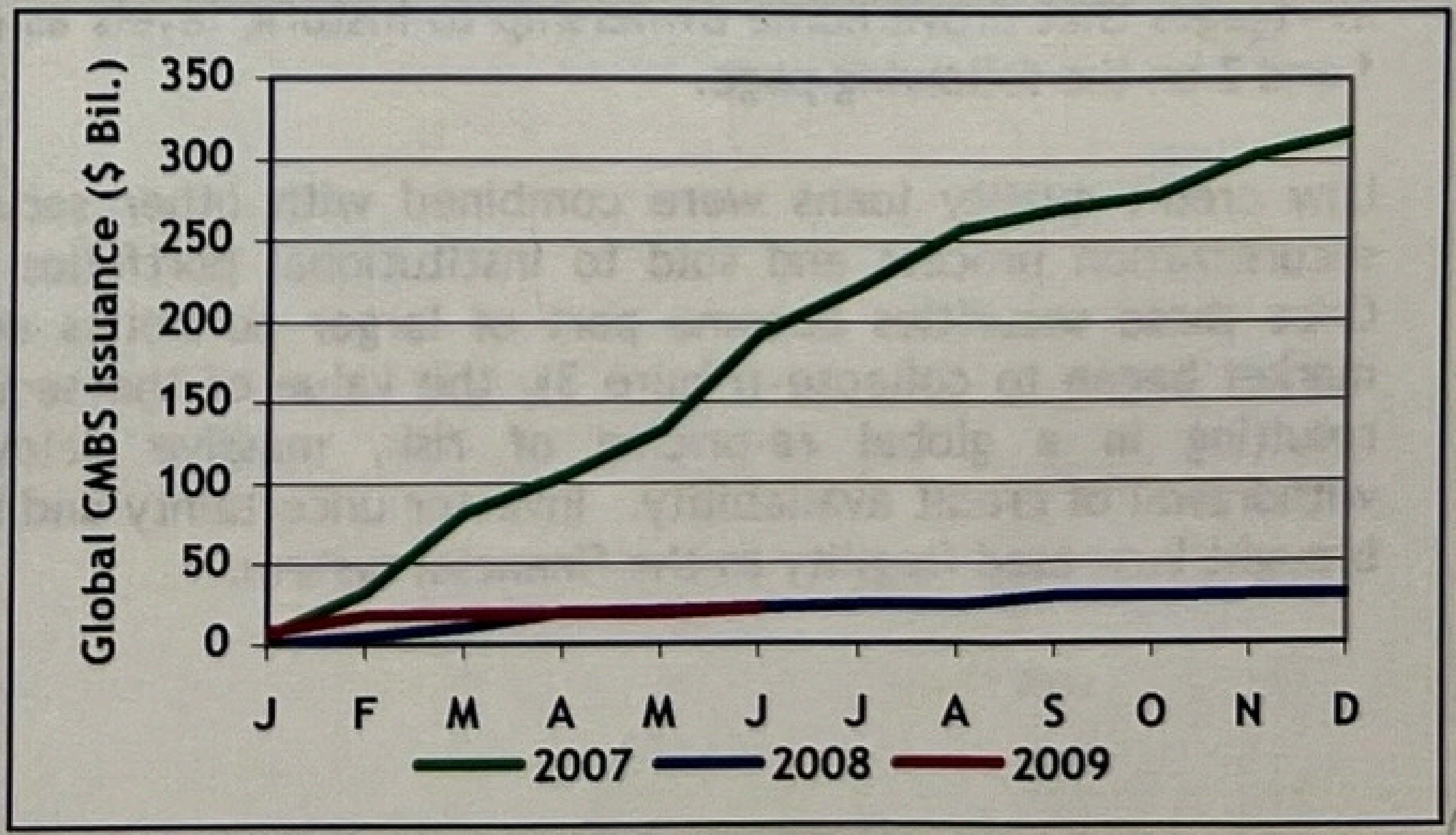
The real estate market has stalled in the midst of limited lending and expensive credit financing. Transaction volume is down 75-80% from previous years, and buyers and sellers are facing a wide bid/ask spread. When the debt cannot be priced, pricing the equity becomes equally problematic.

Figure 4. CMBS Spreads to Swaps



As of 26 June 2009
Source: Barclays

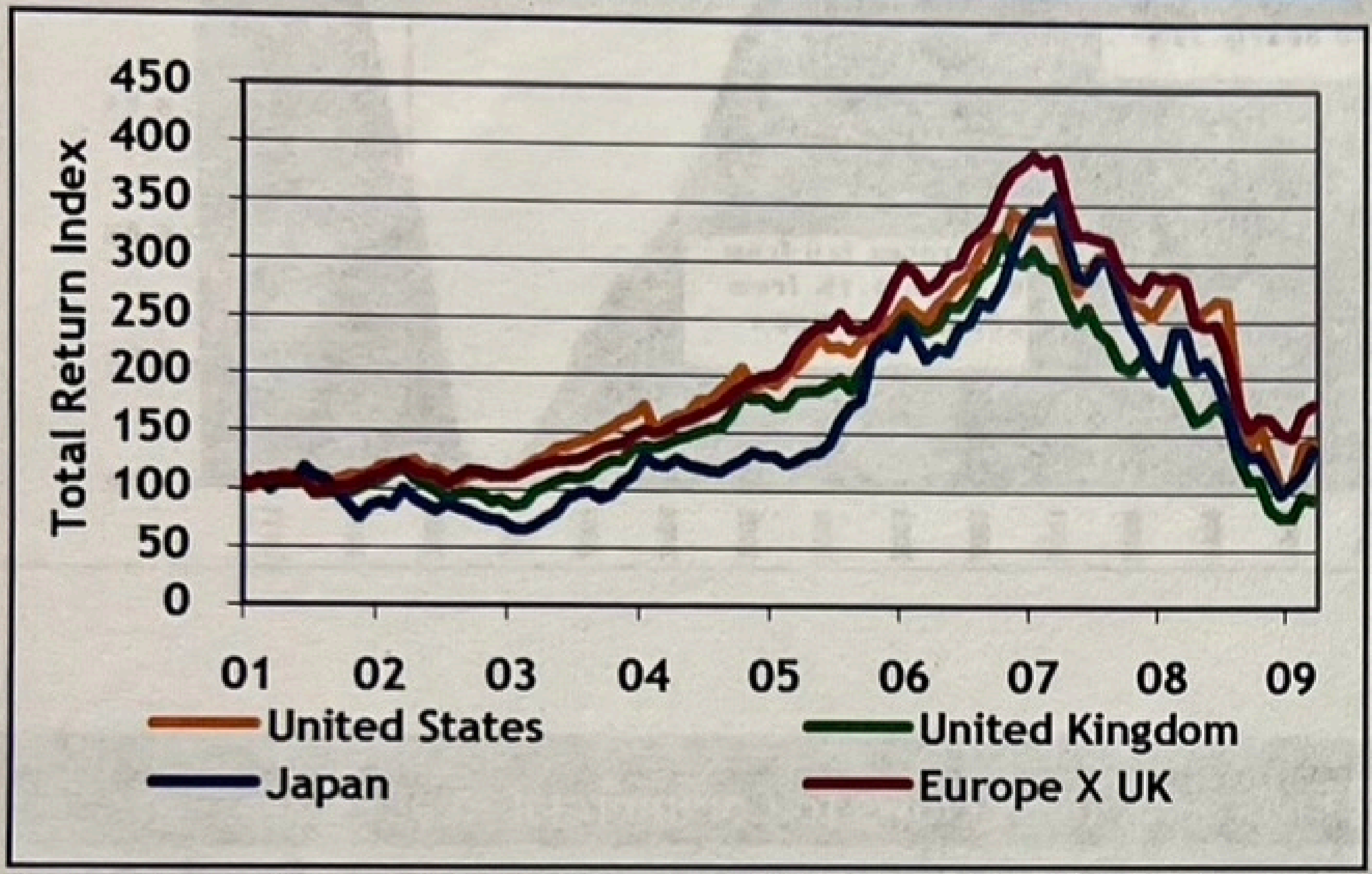
Figure 5. Global CMBS Issuance



As of 29 June 2009
Source: CMA Alert

As the capital market turmoil unfolded, public REITs quickly repriced (Figure 6) as did publicly traded real estate debt. Baa-rated corporate bonds, which typically trade at a small spread to real estate and have tracked closely on a historical basis, showed a 100 basis point spread at June 2009. This data suggests that private equity real estate is in the midst of a material revaluation at a time when cap rates are expanding, revenue streams are becoming increasingly fragile, the economy continues to contract, and unemployment continues to climb (Figure 7).

Figure 6. Global Public Real Estate Market Returns



As of 31 May 2009
Source: FactSet, EPRA/NAREIT; in local currency

Figure 7. US (NPI) Cap Rates vs. Comparable Yields

	Current Yield	LT Yield	Difference
10 Year Treasury	3.5%	7.4%	-3.9%
Global REIT	5.3%	3.3%	2.0%
Aaa Corporate Bonds	5.4%	8.4%	-3.1%
US Equity REIT	6.0%	5.1%	0.8%
NCREIF Cap Rate	6.1%	7.3%	-1.2%
S&P 500 (trailing earnings)	6.9%	5.9%	0.9%
Baa Corporate Bonds	7.2%	9.5%	-2.4%
Investment Grade CMBS	10.5%	5.6%	4.9%
High Yield CMBS	55.7%	13.9%	41.7%

Source: Bloomberg, NCREIF, Moody's, FactSet, REIT yield based on dividend yield; NCREIF as of 31 March 2009, all else as of 26 June 2009

Figure 8. US All Property Derivative Returns (NCREIF)*

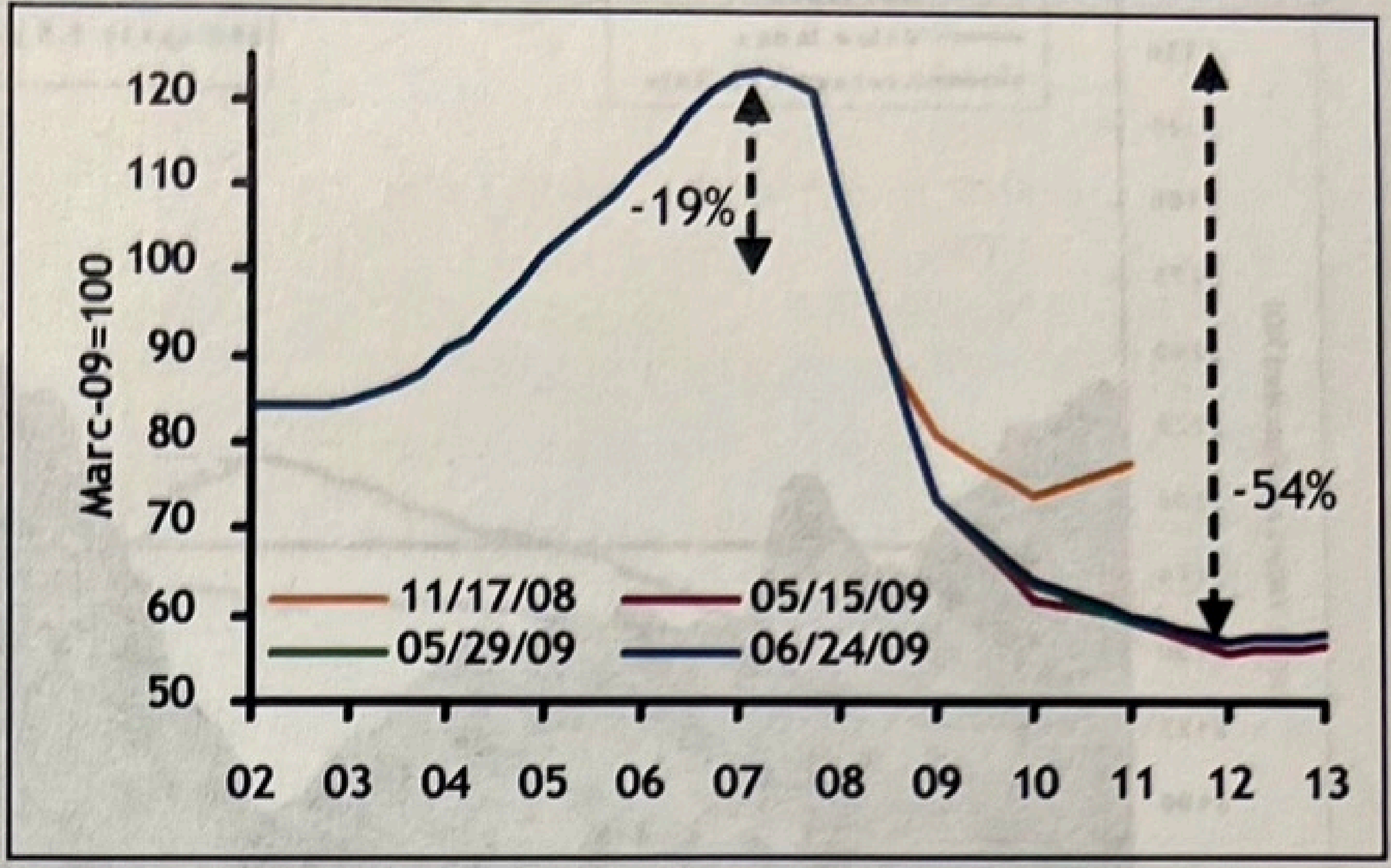


**Chart displays projected returns revised at different dates*

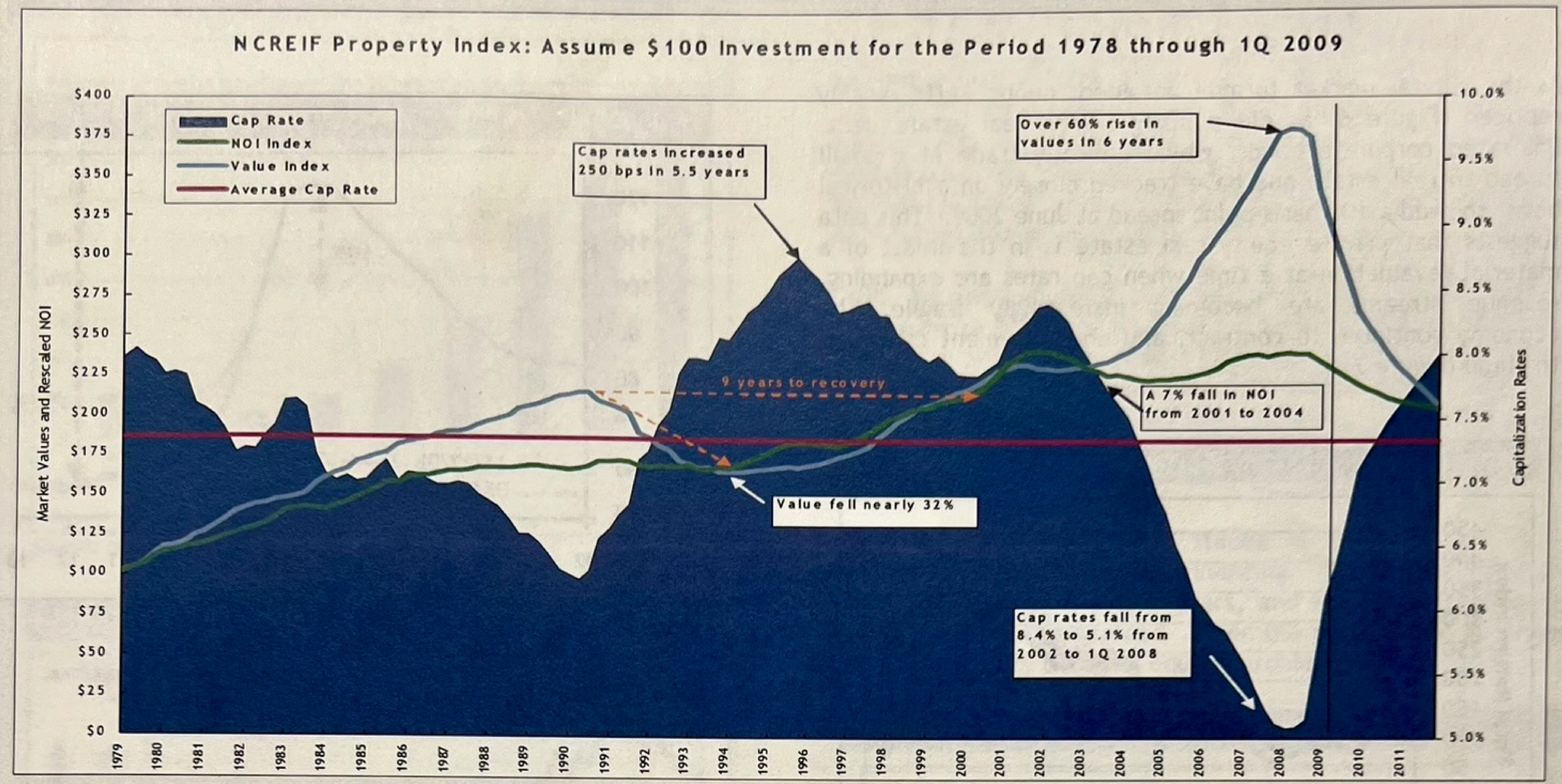
Source: Pricing Provided by Morgan Stanley, Merrill Lynch, BlackRock. US Q407 Pricing is Sept-Sept, Q108 is Dec-Dec, Q208 is Mar-Mar.

Real Estate Performance

Going forward, we expect peak-to-trough value declines of 40-45%, while the derivatives markets are pricing a decline of over 50% as depicted in Figure 8. Through 4Q08 and 1Q09, the NCREIF Property Index (NPI) value has already dropped approximately 19%, which indicates that there is still additional excess that needs to be realized before recovery can take hold. Accordingly, another 20%-25% decline in the NPI can be expected through 2009. The write-downs during this most recent downturn are occurring at a faster pace than in the early 1990s when it took approximately four years for values to go from peak to trough.

Figure 9 on the following page shows that during a period of extreme cap rate compression fueled by a market that was awash in liquidity (Figure 10), cap rates fell from a high of 8.4% to 5.1% from 2002 to 1Q08. During this extraordinary period, net operating income remained virtually flat while market values rose more than 60%. Going forward, cap rates in the spot market are already at or around 8.0% depending on location and property type. Given the nature of market equilibrium, we believe there is a high likelihood that cap rates will overshoot their long-term historical average of 7.0-7.5% before returning to a long-term run rate. If there is room for optimism in this current cycle, it lies in the fact that this real estate downturn is demand-led as opposed to being driven by oversupply, the typical handicap of this industry. New commercial supply has been quite muted, a circumstance that should position the market well when it enters the recovery phase.

Figure 9. Current vs. Previous Downturn



Source: NCREIF and BlackRock

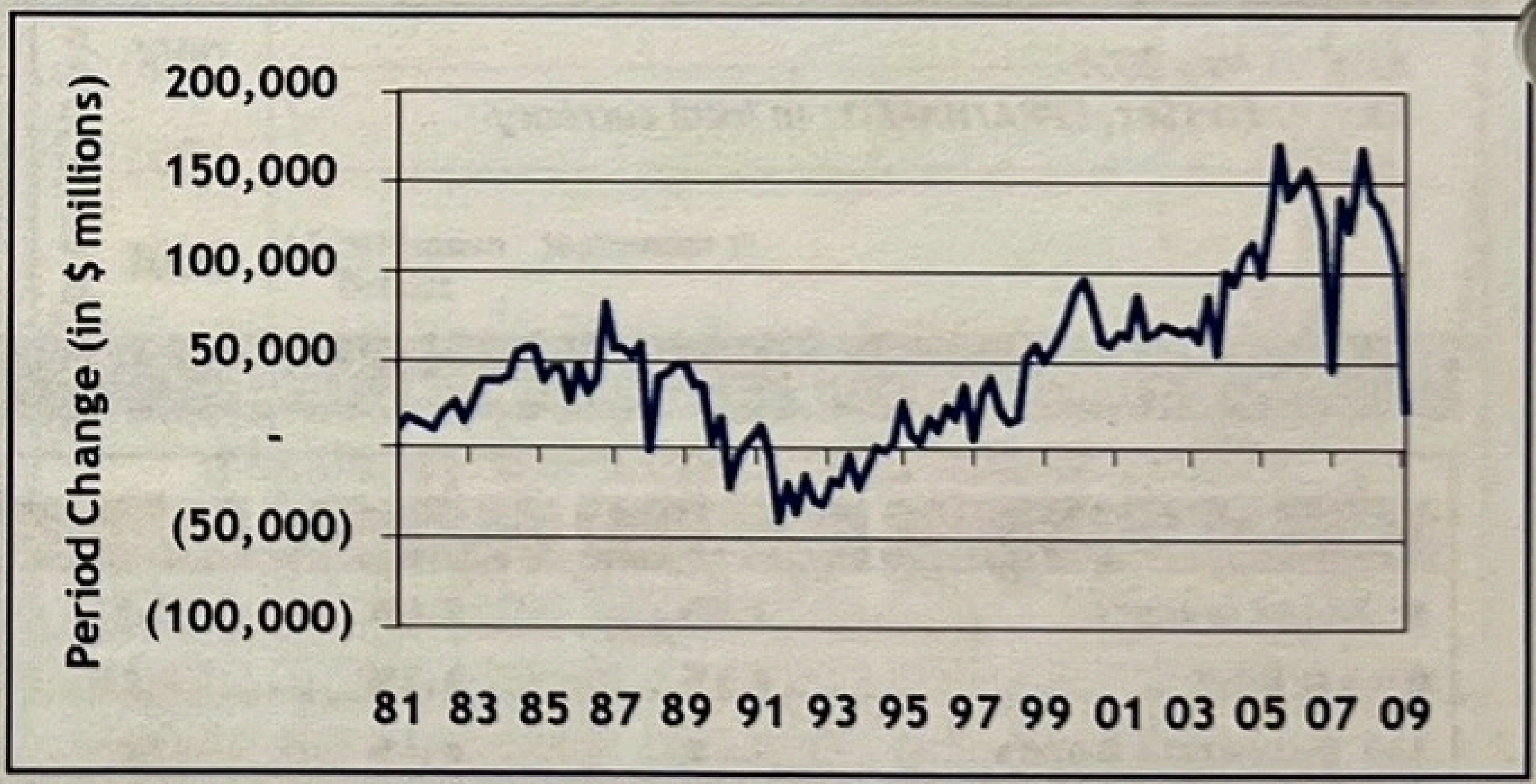
Conclusion

The results of a recent survey of US plan sponsors showed an inclination to focus on core real estate and opportunistic real estate. As real estate reverts to its core attributes (strong consistent yield, downside protection, diversification, inflation protection, and the potential for capital appreciation) investors should have the opportunity to acquire high-quality, well-located assets and may achieve attractive unleveraged risk-adjusted returns. Historically, such returns have been around 8-10%. Investors are keenly aware that what lies before them represents potentially one of the most attractive periods in real estate investing in more than a generation. However, aware that location, pricing, timing, and sponsorship will be the key determinants of successful investing, investors are being extraordinarily cautious.

On the opportunistic side of the spectrum, investors should have the chance to acquire assets from distressed sellers or from banks (Figure 11) that will increase their real estate owned exposure. Additionally, we expect that larger investors will seek more control over their investment portfolios and be able to pay lower fees. This suggests a separate account format rather than a fund format for plans that are large enough.

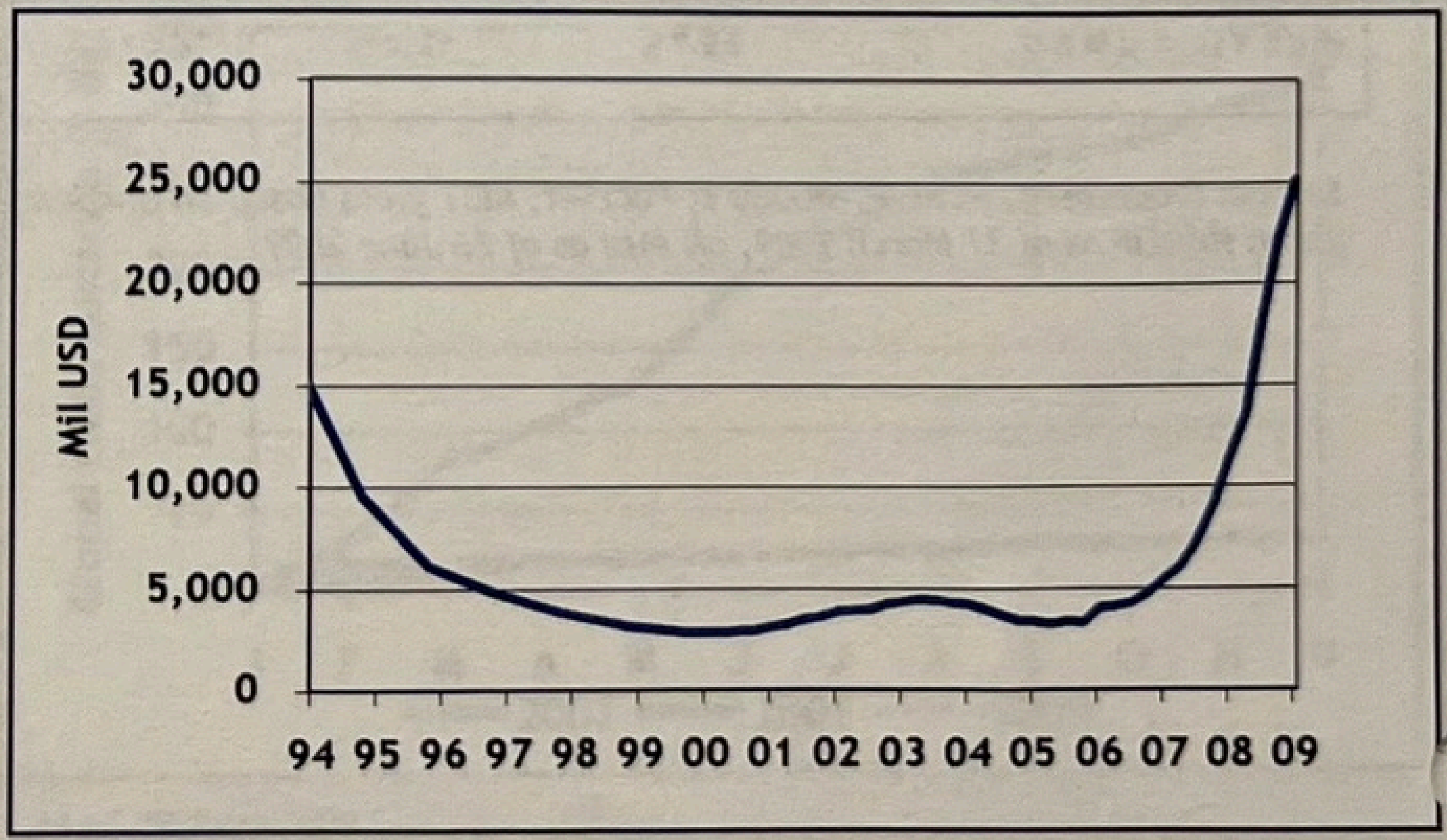
Finally, investors should be deciding which managers with whom they wish to partner and consequently perform their appropriate due diligence on them. As the downturn unfolds, there is a high likelihood that some managers will not survive and that others may be impaired. In this way, when the manager decides the time is right to execute, plan sponsors can move quickly and take advantage of a market that we expect to be full of attractive opportunities.

Figure 10. Debt Flows to Commercial Real Estate



As of 31 March 2009
Source: Federal Reserve; Incl. construction & development loans; Seasonally adjusted

Figure 11. Bank Real Estate Acquired Through Foreclosure



As of 31 March 2009
Source: FDIC