WHARTON REAL ESTATE REVIEW SPRING 2012

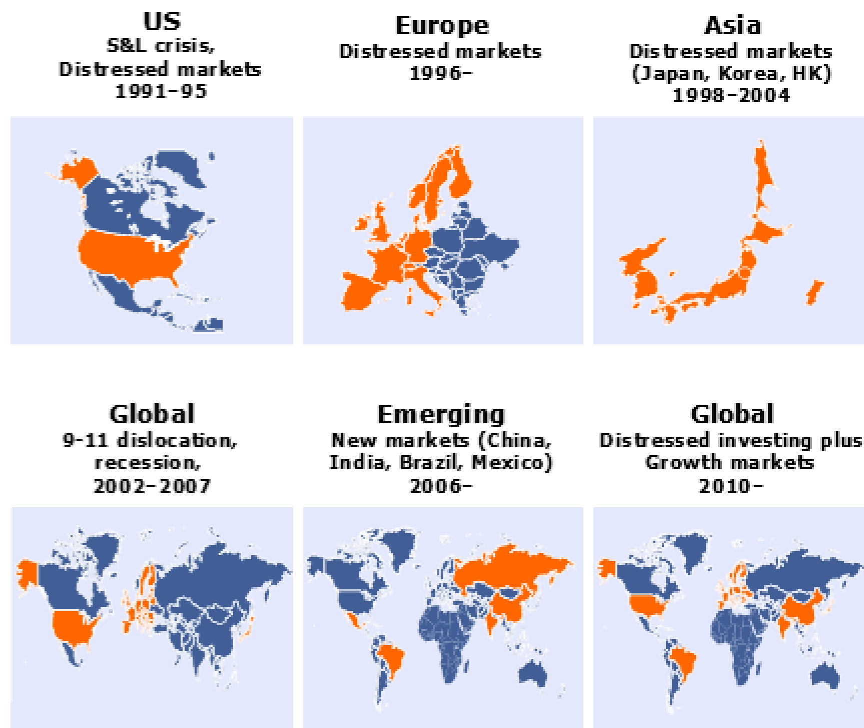
Twenty Years of Opportunistic Real Estate Investing

JOANNE DOUVAS

The history of real estate opportunity funds is a twenty-year search to take advantage of cycles of distress and the scarcity of capital. Real estate opportunity funds have evolved in response to capital market dislocations and illiquidity over the course of the market cycles.

Cycles of distress and scarcity of capital have affected the geographic distribution of funds over their short history. Opportunity funds were first created in the late 1980s to take advantage of the distress following the S&L crisis, with the Resolution Trust Corporation (RTC) as one mechanism to transition broken capital structures back to the functioning marketplace. The opportunity to restructure distressed debt took funds to France and then Italy in 1996, Japan in 1998, and Germany in 2003. By 2004, funds in the United States turned to making money through capital market arbitrage—using a high degree of leverage to ride the cap rate compression of private companies. When the world's developed markets became over-priced due to the first-ever globally linked cyclical upturn, investors turned to the emerging markets of China, India, Brazil to develop new product. Following the global financial crisis, and a pause, the opportunity again became one of taking advantage of the distress in the mature markets, this time Japan, the United States, the UK and Europe (Figure 1).

Figure 1: Changing opportunity set for opportunistic returns



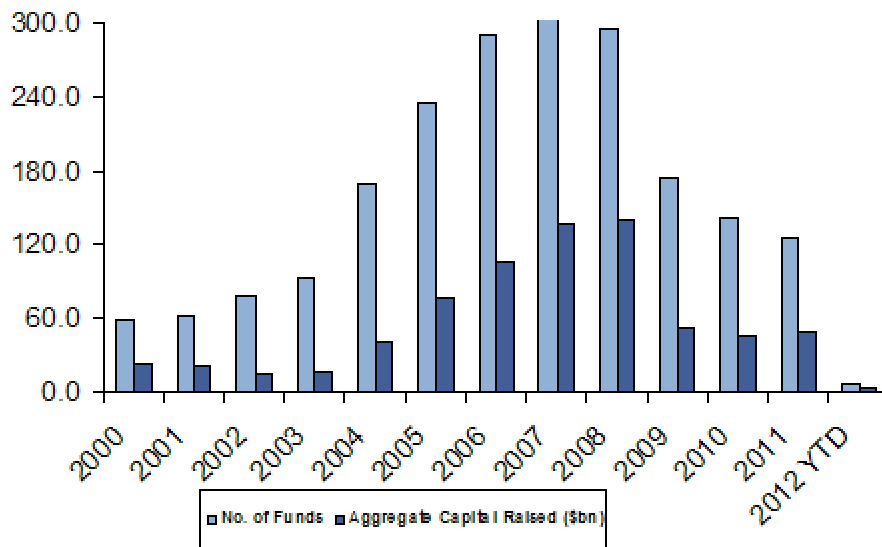
The structure of the first real estate opportunity funds was borrowed from private equity limited partnerships: closed-end limited partnerships with an eight to twelve-year life, a fund management fee (ranging from 1.0 to 1.5 percent, depending on the commitment size) and an incentive fee known as carried interest that is typically 20 percent of total

profits. The target levered return is generally in excess of 500 basis points over that of core real estate. The target net return to investors is generally in the range of 16 to 20 percent. Real estate opportunity funds use a broad palette in response to market conditions and may take advantage of cycles of distress, structural changes in ownership, repositioning and conversion, and the creation of new real estate. Investing through cycles of distress includes buying distressed loans and loan portfolios, mispriced CMBS, recapitalizing assets, and acquiring out-of-favor or specialized real estate (such as resorts, distressed healthcare, casinos, marinas, student housing, senior housing, storage, and land). Structural changes in ownership include the divestiture of public or corporate properties, sale-leasebacks, and public-private arbitrage—take-privates and IPOs. Repositioning and conversion include the renovation and lease-up of old stock, change of use, and the transitioning of B properties to A. The creation of new real estate stock includes ground-up development as well as gap-funding to development projects.

Size and Capital Flows

Over time, the competitive landscape between winners and losers has become more stratified. Those with early success were able to raise increasingly larger funds that continued to garner large capital commitments unless market re-pricings derailed or exposed investment flaws. The largest funds raised to date are Blackstone VI ($10.9 billion raised in 2007), MSREF VI ($8.8 billion raised in 2007) and Lone Star VI ($7.5 billion raised in 2007). Blackstone VII has just reached $10 billion as of this writing and is on target to be the largest. According to data from Prequin, capital formation peaked in 2008 with $140.8 billion raised by 295 funds comprising all strategies. Following the global financial crisis, capital raising has been muted with only $28.1 billion raised in 2011 by 126 funds.

Figure 2: Capital formation



Source: Prequin

The first funds were initially formed primarily to buy loans or assets from the RTC, which Congress created to manage and sell the troubled real estate assets of closed S&Ls and maximize asset recovery for taxpayers. Assets were initially sold through bulk sales and then through equity partnerships. The RTC used a number of programs including securitized bulk sales (the M-series), and two retained interest programs: seven N-series transactions initiated at the end of 1992 ranging in size from $100 million to $300 million; and two Multiple Investor Funds, large blind-pool transactions closed in January 1993, with more than 1,000 loans with a book value of $1.2 billion and a derived value

of $982 million. During its six-year life span, the RTC sold $403 billion of assets from 747 insolvent thrifts. The ultimate cost of the S&L crisis is estimated to total $160.1 billion, about $124.6 billion of which was directly paid for by the U.S. government.

The first funds established using a private equity structure were the Zell-Merrill I Real Estate Fund ($409 million in 1988) and AEW Partners Fund I ($875 million raised in 1988), each raised prior to the market correction of the early 1990s. The funds that followed were created specifically to take advantage of the distress and included: Starwood Capital ($52 million in February 1991); Goldman Sachs' Whitehall Funds ($145 million in December 1991 and $805 million in November 1992); Colony Capital Fund I ($394 million in December 1991); and Morgan Stanley's MSREF I ($490 million in June 1992). Others, such as Lehman Brothers and Bankers Trust invested similarly in opportunity funds but used balance sheet capital and raised funds later in their evolution.

One of the first investments of MSREF, in conjunction with LNR Property, involved the purchase of the AmeriFirst Savings and Loan portfolio from the RTC in late 1991 and early 1992. It was a $1 billion portfolio of approximately 1,100 assets, mostly loans secured by commercial properties and residential land. MSREF invested $57 million and produced a 67 percent IRR and a 3.0x equity multiple. Another early MSREF investment was the acquisition of loans from Bank of America resulting from its acquisition of Security Pacific Bank. Profits for MSREF were in excess of $530 million, with an IRR of 124 percent and an equity multiple of 8.9x on an investment of $70.6 million of equity.

After the initial success of the early funds, new funds included: Apollo Real Estate Partners I ($500 million in 1993); Blackstone Real Estate Partners I ($467 million in 1994); Westbrook Fund I (a spin-out from MSREF ($684 million in March 1995; and Brazos Partners, since renamed Lone Star Opportunity Fund ($247 million in March 1995). For the most part, these early opportunity funds achieved large equity multiples and IRRs. For example, Brazos was originally formed as a partnership with the FDIC to purchase and liquidate the "bad bank" assets of American Savings Bank, which had been purchased from the RTC. Brazos resolved more than 1,200 assets in thirty-two states, comprising $2.5 billion of distressed real estate loans and properties, made profits of $150 million; an IRR of 423.2 percent and a 6.5x equity multiple.

By December 1995, the RTC was wound down and the real estate opportunity in the United States was to make money through the acquisition and asset management of hard assets— renovation/rehab and lease-up—using substantial leverage. Capital was returning to the market and sales activity by institutional owners such as Travelers Insurance was occurring. Liquidity was returning to the market, and REITs were forming as a means to recapitalize troubled developers and de-lever with public capital. The real estate market was in recovery, rental growth was poised to spike and capital starved assets were in need of improvement.

France and Italy

By 1996, Western Europe was emerging from a significant recession. Its real estate market mirrored that of the United States during the early 1990s. A joint venture of Lehman Brothers, Cargill and LaSalle acquired the first loan portfolio in France (from Barclays Bank. Whitehall, however, established a first-mover advantage early in the market's recovery cycle by acquiring several non-performing loan portfolios (from Group Suez and state insurance group UAP). The focus on France was based on: the size and depth of the French market; favorable emerging economic trends; stabilizing real estate market rents and occupancy levels; and the pressure on financial institutions to divest non-performing real estate assets. Whitehall formed Gestion d'Actifs Haussmann (GAH), a joint venture with European developer Shaftesbury. Capitalizing on its market leadership position, in 1998, GAH and its financial partners acquired the failed Union Industrielle de Crédit bank (UIC) from the Groupement des Assurances Nationales (GAN), a state-owned insurance company that was in the process of being privatized. GAH de-licensed and

restructured the bank, merging its operations into GAH and creating Archon Group (France), which became one of the largest privately-owned real estate asset management companies in Europe. Subsequently, GAH acquired a dominant share of the distressed loan portfolio market in France.

While Whitehall had effectively shut out MSREF from buying NPLs in France, MSREF focused on Italy. MSREF, in turn, shut out Whitehall from buying NPLs in Italy by buying the country's only special servicer, Servizi Immobiliaria Banche SpA (SIB). To provide workout services to its NPL portfolios, MSREF created an asset management affiliate, MS Corso Venezia.

Japan

By 1998, the large opportunity funds shifted focus to NPLs in Japan as its economy was entering a period of recovery resembling Europe five years prior. Japan had been suffering since 1990 from the most severe and prolonged economic crisis in its modern history. The government had guaranteed the viability of banks, which encouraged aggressive lending and poor credit discipline. Most Japanese corporations incurred substantial real-estate-secured debt during the real estate bubble, making property a key element in financial restructuring. The Financial Services Agency (FSA) estimated in September 2001 that total problem loans totalled over ¥35.7 trillion (US$274.4 billion as of September 2001), of which ¥22.6 trillion (US$174.1 billion) were estimated to be NPLs. An additional US$450 billion was considered to be "at-risk" problem loans. A Goldman Sachs study estimated that the problem loans could have been five times the amount estimated by the FSA. The government initiated an important restructuring effort focusing on deregulation and increased transparency.

The FSA increasingly forced lenders to become tough on weak borrowers, especially smaller borrowers, forcing many corporations to restructure or face bankruptcy. While it took a long time for either volume or quality loan portfolios to be sold, opportunity funds positioned themselves to acquire what was anticipated to be a large volume of distressed loans. There were virtually no special servicers in Japan so the funds created their own asset management affiliates to service and resolve these loans. The largest acquirers of NPLs were Lone Star, Whitehall, GECC (with balance sheet capital) and MSREF. The first dedicated funds for Japan were raised by KK daVinci ($434 million in November 2002), Aetos ($840 million in December 2002), and Secured Capital Japan ($118.6 million in 2004). Global funds that entered the Japanese market early included Lone Star, MSREF, Grove International, Starwood, Westbrook and Whitehall. Completely absent from Japan was Blackstone.

The opportunity in Japan was to buy performing, under-performing, and non-performing loans, real estate hard assets from corporate restructurings (divestiture of under-managed non-core real estate-related assets), and poorly managed assets (lower quality assets owned by unprofessional owners who hadn't operated their properties to optimize financial performance). Banks commonly sold assets on a quiet negotiated basis at prices that were well below market had they run a competitive process—allowing the bank to "save face." With initial yields of 8 percent and financing at 80 percent LTV at an all-in interest rate of 1.5 percent to 2.3 percent, large returns were possible prior to growing NOI through operating efficiencies.

Streamlining in Western Europe

By the end of the 1990s, opportunities in Western Europe broadened beyond NPLs as a result of a number of factors: pan-European economic recovery; an expectation of accelerated growth and sustained rental growth; a low interest rate environment as a result of the European Monetary Union; an increased demand for development and redevelopment in Western Europe; a lack of modern office facilities in Central and Eastern Europe; increased liquidity and depth of European capital markets; and consolidation of financial institutions and corporate and

government streamlining resulting in sales of real estate portfolios. In Western Europe, a vast portion of the real estate stock was owned by government-controlled entities, industrial groups, and banks. Their lack of strategic interest in their real estate assets resulted in significant operating inefficiencies in their portfolios. While trying to dispose of their non-core holdings, these groups faced the challenge that a large portion of their assets needed to be fundamentally repositioned in order to be appealing to long-term investors seeking a stabilized and predictable current yield.

In 1999 and 2000, a number of pan-European funds were formed, many by former members of investment bank sponsored funds. These included Doughty Hanson ($632 million), Orion (€476 million), Europa Capital (€225 million), Soros Real Estate Investors ($1 billion), and Blackstone International ($694 million). These were followed by Apollo International ($336 million) and Patron Capital ($110 million). While European funds were focused on hard assets, the Japan-focused fund managers began to look more broadly across Asia at NPLs and then hard assets. By 2003, there were believed to be NPLs totaling $1.2 trillion in Japan, $500 billion in China, $300 billion in South Korea and $40 billion in Taiwan.

U.S. Recession and Dot.com Bubble

After the end of the dot.com bubble and 9/11, interest rates declined while property fundamentals improved. The opportunity for some became buying core-like assets with high leverage and holding them just long enough to make improvements, then selling at a much lower cap rate. Managers such a Beacon Capital and Blackstone were able to ride the cap rate compression while cleverly improving value through astute asset management, resulting in substantial profits. In 2003, the question investors began asking was "Why are we paying managers 20 percent of profits for leveraging core assets when total fees for Core with 67 percent leverage are a gross to net spread of 210 basis points?" ("Opportunity Funds: Reining in the Fees," Wharton Real Estate Review, Spring 2004) The solution was to delay the hurdle at which the carry catch-up begins. For those who sold prior to the onset of the September 2008 global financial crisis, returns were often spectacular. For those who failed to sell, the effects of leverage combined with severe value declines was devastating. At the peak of the market in December 2006, Beacon was able to sell the last ten investments in its Beacon II, making returns of 44.1 percent and a 2.5x equity multiple. Investors who co-invested in the Beacon II John Hancock portfolio realized net IRRs of 52 percent and an equity multiple of 3.5x. In the third quarter of 2007, Beacon was able to sell all of Beacon III to Broadway Partners. However, the transaction that symbolized the market peak was Blackstone's acquisition of EOP, the largest-ever leveraged buyout. This was a $36 billion acquisition that Blackstone tied up in October 2006, utilizing the remaining 39 percent of BREP V capital, requiring Blackstone to immediately raise the $10 billion BREP VI to fund the remaining half of the equity. By the time Blackstone closed on the investment, they had arranged to flip many sub-portfolios to various other funds, and in some cases, Blackstone further flipped sub-sub portfolios (allowing their buyer to reap the profit from the second flip)—all before closing.

French and German Residential

In August 2002, Westbrook Partners planned to bid for French public company Simco, whose real estate holdings were equally split between office and residential. Westbrook intended to immediately flip the office portion and focus on a condo conversion process in the residential portion. This plan was initially spoiled when the two major shareholders pledged their shares, not to Westbrook, but to another public company, Gecina. However, the following year, Gecina sold 3,200 rental apartments in Paris to Westbrook Partners for €1.2 billion—half from Simco and half from their own holdings. Westbrook successfully converted the apartments to condos (technically co-ops) and achieved their underwritten return of a 32 percent IRR without an expensive tender process.

In 2004-2005, Germany was facing increasing budget deficits, high unemployment, and low economic growth following years of economic stagnation. As a result, there was pressure to implement financial reforms. The opportunity was to buy German housing companies and portfolios from corporations and the state, which needed to generate cash and meet regulatory requirements. The German government and industry owned an estimated three million residential units (14 percent of the residential market). In 2004 alone, more than 220,000 residential units were sold in four major transactions, the largest of which was Fortress's acquisition of the German housing company GAGFAH, from the German social security and pension agency. Others were the GSW purchase by Cerberus/Whitehall, WCM by Blackstone, and Thyssen Krupp Immobilien by MSREF/Corpus—each for more than €1 billion. From 2002 to 2004, the number of residential units acquired increased from 20,000 to more than 260,000 and the number of transactions increased from two to twenty-six.

The strategy for these acquisitions was to convert rent-controlled units to condos, since Germany had the lowest homeownership rate in Western Europe. However, these funds miscalculated the desire for Germans to own rather than rent and performance was generally disappointing. In 2004, German banks off-loaded bad loans with a face value estimated at $13 billion to $16 billion, with Lone Star buying as much as two-thirds of the total. In a single deal, Lone Star acquired troubled loans with a face value of $4.8 billion from Hypo Real Estate Group, a spin-off of HVB Group.

Public To Private Arbitrage

Beginning in 2004, the opportunity emerged to take public companies private, thereby capitalizing on an arbitrage opportunity embedded in pricing differences between public and private markets. In these transactions, value is unlocked by reducing overhead costs and increasing leverage for a scalable platform. The private owner can use higher leverage than the public company and can convert high-cost corporate unsecured property debt to securitized CMBS financing. The conversion of public C-Corps to REITs or LLCs can also eliminate double taxation. The commingling of operating and property businesses in the public model clouds the values of each portion. By splitting the company into an operating company and a property company (an "Op-Co" and a "Prop-Co"), a higher multiple can be applied to the property company such that the value of the components at exit is higher than at set-up. This strategy also takes advantage of wholesale-to-retail discounts by selling the component parts of a company for maximum price, what became known as the "chop-shop" approach. Additionally, the true value of land and other non-income producing assets are often not fully captured in public valuations. Overhead savings include elimination of public company costs, consolidation of operations and outsourcing. Operational improvements include improved operating margins, cost reductions, revenue maximization and space re-measurement. This strategy can result in a quick return of capital as assets that are not central to the longer term strategy are flipped out. The platforms provide dedicated management teams at a cost that is less than that of third-party service providers.

Blackstone, with its large funds, was most able to take advantage of this opportunity. In 2004-2005, it acquired Extended Stay America, Prime Hospitality, Boca Resorts, and Wyndham Hotels. Blackstone continued to take companies private through the 2007 peak, with its privatization of EOP marking the peak of the market. Conversely, Fortress took a number of companies public beginning in 2004, including Aircastle Limited, Brookdale Senior Living Inc., GAGFAH S.A., GateHouse Media, Global Signal Inc. and Mapeley Limited.

Emerging Markets

In 2006, as the assets in mature markets were perceived by some to be over-priced, focus shifted to the emerging markets. In Brazil, Russia, India and China—which became known as the BRICs—the economies, employment and real wages were growing at a rapid rate. The result was a burgeoning and urbanizing middle class in need of new real

estate products of all kinds—office, industrial, residential, retail and hotels. Greater disposable income, expanding middle and upper income classes, changing social patterns, booming consumer confidence and the availability of mortgage loans led to the need for new residential and retail. A growing presence of new companies and tourism led to a growing need for new hotels, particularly those catering to the mid-market business traveler and the domestic tourist. In India, growth was fueled by the explosion of the IT/ITES industry and the proliferation of offshoring by Western and multinational companies. Growth in Russia and Brazil was fueled by trade surpluses from strong commodities exports. China was in the process of evolving from a period in which growth was driven by foreign investments and exports, to one in which the economy was fueled by private consumption.

The primary funds raised in India in 2006 and 2007 were by FIRE Capital, IREO, IL&FS, JPMorgan, Kotak, Red Fort, SUN Apollo and Xander. In China, the largest funds were raised by Gaw Capital (the Gateway Capital funds) and Winnington Capital (the Trophy funds). In Russia, funds were raised by Jensen, Marbleton (sponsored by Alfa Capital and JER), and Rutley Capital. In Brazil, funds were raised by Brazilian Capital, GTIS, Hines, Paladin, Patria, Prosperitas, Tishman Speyer and Vision Brazil. While these markets were all impacted by the global financial crisis to some extent, most of these funds proved to withstand the downturn better than funds in the mature markets, due to better market fundamentals and very low leverage.

Global Financial Crisis

The world's first-ever globally linked cyclical upturn led directly to a corresponding cyclical downturn following the bankruptcy of Lehman Brothers. The aftermath: recessions in the United States, the United Kingdom, Europe, and Japan, and a deleveraging process that continues to this day.

The amount of debt set to mature over the next few years is estimated at US$2.2 trillion. Meanwhile, a report by DTZ estimates that the capital required to recapitalize the debt, given current market valuations and debt financing parameters, is US$142 billion globally, of which US$122 billion is in the United Kingdom and Europe and US$22 billion is in Japan. Many real estate loans that were set to mature in 2009-2011 have been extended by banks and servicers in order to avoid equity and debt losses in hopes for a rebound in capital values. This strategy has been facilitated by a low-interest rate environment and certain tweaks to government regulations; for example, banks are no longer required to classify an entire loan as impaired, and so long as a property is paying current, only that portion that exceeds property value needs to be written down.

The result of this strategy is that the real estate market has split into two segments: *slow*or *stuck*. The slow part of the market comprises properties with clean capital structures that are well-located and well-leased and trading at premium values, though not at pre-Lehman levels. The stuck part of the market is composed of properties with broken capital structures (or properties in tertiary locations) that are simply not trading. The stuck part of the market will be the significant money-making opportunity over the next several years. Opportunities related to broken capital structures stem from a variety of sources, most notably five major categories: borrowers facing maturity, banks, governmental catalysts, special servicers and distressed owners.

The financial crisis of 2008 punished the most highly leveraged funds and those who had lost investment discipline during the froth of the market. Poor performance, combined with Dodd-Frank regulations, has caused most of the investment-bank-sponsored platforms to jettison their real estate private equity platforms. This has opened the playing field to new entrants with the skill set to acquire loans and loan portfolios, execute foreclosures and loan workouts, and asset manage real estate upon taking title.

Distress in Japan

Following the global financial crisis of 2008 the opportunity to take advantage of distress in the mature markets appeared first in Japan, although few funds remained to take advantage of the opportunity. The large investment bank-sponsored funds plus a few others had either retreated or were absorbed with legacy problems and no longer actively investing in Japan. The remaining players include Fortress Japan ($800), SCJ Japan ($525 million in SCJ IV plus $181 million sidecar fund for NPLs), and Aetos ($250 million in Aetos IV). The opportunities in Japan are from four main sources.

Forced sales of CMBS. As holders of senior CMBS positions refuse to extend loan maturities, there will continue to be opportunities for funds to acquire assets through forced sales. At the time of the financial crisis, CMBS constituted approximately 4 percent of total outstanding commercial mortgages in Japan (compared to approximately 25 percent in the United States), US$44.2 billion of these CMBS maturing between 2010 and 2013. By the terms of Japanese CMBS, 100 percent bondholder approval is required for extensions. Many large holders of Senior A positions want to exit, and thus are not approving extensions, thereby forcing sales of entire facilities.

"*Hung loans" from balance sheet lending banks.*Opportunities for funds to acquire so-called hung loans are due to the particularities of Japanese governmental rules. The government has made it difficult to pool loans by requiring that buyers perform separate underwriting for each security. The majority of sellers have been foreign banks that were issuers of CMBS and ended up holding the hung loans on their balance sheets when the CMBS market collapsed.

*Non-performing loans from banks.*The US$300 billion of outstanding non-recourse debt represents another capital opportunity for funds. Asset re-pricing since the start of the global financial crisis caused a large portion of this debt to become impaired, and Japan's Financial Services Agency has been applying pressure on certain banks to reduce their ratio of impaired loans.

Corporate distressed debt and assets. Bankruptcies have to lead to opportunities for funds in the real estate-related corporate debt market, specifically corporate bonds and whole loans. An estimated US$12 billion of recourse loans made to Japanese property companies and corporations is sub-performing, and the number of forced sellers of distressed real estate assets has steadily increased.

Distress in the United States

Following the global financial crisis, distress opportunities were slow to emerge in the United States. The initial source of opportunities was those out of the FDIC, beginning with the Starwood acquisition of the Corus Bank portfolio in October 2009. By 2010, transactions were plentiful for those with the requisite skill set. There are a number of different opportunities.

*Portfolio acquisitions from the FDIC.*The opportunity is to acquire banks and loan portfolios directly from the FDIC, especially as it continues to seize banks and clear assets. From January 1, 2008 through February 10, 2012, the FDIC seized 423 banks with a total of US$631 billion of assets; at the end of 2011, approximately 814 banks with US$319 billion of assets were on their watch list, many of them regional banks. Since May 2008, the FDIC has executed thirty-one structured loan sales, the largest of which was the Corus Bank portfolio sale in October 2009 for US$551 million of required equity (US$4.4 billion book value). Few managers have the necessary platform in place to successfully invest in these often complex asset-disposition transactions. Core property buyers lack the skill set to engage in complex investments; only a handful have the internal capabilities to perform workouts on large portfolios of very small-balance loans. Generalist distressed investors may lack the direct property experience. And hedge funds often lack all of these attributes.

*Direct acquisitions from banks.*The opportunity is to acquire loans and loan portfolios directly from banks at deep discounts to intrinsic value, with ultimate loan resolution through negotiated discounted payoffs, modifications or foreclosure. As banks jockey for survival, the expectation is that certain banks will survive by acquiring others. In order to acquire other banks, the FDIC, in some cases, is suggesting to relatively healthy regional banks that they first need to cleanse their own balance sheets of impaired loans. This presents an opportunity for funds to partner with the banks to acquire these portfolios through joint-venture arrangements, potentially taking warrants in the bank. In situations where the bank is unhealthy, a loan portfolio would be acquired outright.

*Portfolio and single-asset acquisitions from special servicers.*The opportunity is to acquire assets and loan portfolios from CMBS special servicers. In particular, CMBS portfolio sales—an ever-larger component of the resolution strategy for the special servicers, who held US$88.7 billion in serviced assets as of March 2011—are a growing area of opportunity. Significant liquidity and maturity deadlines will provide a robust pipeline for managers with the skill set to execute.

*Restructurings and recapitalizations.*Theopportunity is to provide fresh capital to the large stock of real estate with capital structures that are "stuck." These structures are burdened by essentially worthless equity, and debt worth far less than face value. In many cases, particularly with loans made by regional and community banks, borrowers provided recourse guarantees, and for their part lenders are ill-prepared to take back and operate the respective properties. These situations can be ameliorated through a tri-party capital agreement among the borrower, lender, and fresh equity. The result is a loan loss realization by the bank and, perhaps, a new loan to the new equity provider, with relief from recourse guarantees for the borrower. The borrower might be paid some share of future upside in return for cooperation with the restructuring.

Distress in Europe

As in prior cycles, Europe greatly lags the United States—this time by as much as two years. Three and a half years after the crisis began, the banks in Europe are still engaged in "extend and pretend" activities.

*Acquisition of loan portfolios from banks.*There are expected to be increasing and sizable opportunities for funds to acquire real estate assets and loans from banks that consider the assets non-core or non-strategic to their business. A number of European financial institutions—primarily UK, Irish, German and Spanish banks—have on their balance sheets large portfolios of distressed commercial real estate loans and foreclosed assets. In total, CB Richard Ellis (CBRE) estimates some €970 billion of commercial real estate loans are outstanding across Europe, 60 percent of which are held by UK and German banks. Approximately 47 percent (€445 billion) involves high loan-to-value ratios, of which half is secured by poor-quality loans. Outstanding commercial property debt on the books of UK banks totals approximately £230 billion, of which 25 percent (circa £55 billion) is non-performing. According to CBRE, RBS (83 percent government-owned) and Lloyds-HBOS (41 percent government-owned) together hold approximately 35 percent of outstanding UK commercial real estate debt. In addition, another£50 billion of CMBS remains outstanding. In Spain, banks' and savings institutions' overall exposure to real estate developers totals €239 billion, of which problematic loans total €141 billion. These loans are beginning to be systematically liquidated or restructured with third-party equity; since mid-2010, workout activity has gained momentum. As an example, in December 2011, Lone Star Real Estate Fund II (the seventh fund in a series with $5.5 billion raised in 2011) acquired a £900 million (€1.1 billion; US$1.4 billion) loan book from UK bank Lloyds Banking Group.

*Acquisition of non-core assets from corporations.*Similar to the bank-based opportunity described above, there will be opportunities to acquire real estate assets from corporations that consider the assets non-core or non-strategic to their business.

*Acquisition of loans/assets from NAMA.*The Irish government continues to seek ways to generate liquidity, and the National Asset Management Agency (NAMA) is expected to play a central role as it continues to work through its real estate loan portfolio. NAMA was created in November 2009 when it acquired the debt of Allied Irish Bank, Anglo Irish Bank, Bank of Ireland, EBS Building Society and Irish Nationwide Building Society. As of year-end 2011, it had a loan book of €74.2 billion and had sold€4.6 billion of loans over the prior two years. NAMA is specifically looking at ways to provide financing to purchasers of property that is currently under control by NAMA debtors or receiverships engaged by the agency. In December 2011, NAMA sold a€600 million (£515 million) nominally-valued loan portfolio to Orion Capital for €326 million (£280 million), reflecting a 46 percent discount. The portfolio consisted of forty development loans lent to Cyril Dennis in the UK, France and Italy.

*Direct acquisition of real estate.*There areopportunities to provide fresh equity to properties with broken capital structures. Fallout from the global financial crisis has led to re-pricing of real estate at lows not seen for a decade: Investment Property Databank all-property values have not quite recovered to 2001 levels and are more than 60 percent below their 2007 peak. The European funds executing opportunistically include Activum, AREA, Benson Elliot, Blackstone, Brockton, Carlyle, Lone Star, Mountgrange, Niam, Orion, Patron, Resolution, Starwood and Sveafastigheter.

Conclusion

The history of real estate opportunity funds is a twenty-year search to take advantage of cycles of distress and the scarcity of capital. Opportunity funds identify dislocations and illiquidity in real estate markets that have historically shifted geographically over time based on where the market is in the real estate cycle. The availability of excess returns for those managers who know what they are doing and who possess the requisite skill set to execute opportunistically is expected to continue. The opportunity for funds to achieve higher returns has become truly global in nature and these geographical shifts can also be expected to continue.

Copyright 2012 Joanne Douvas.