



METROPOLITAN REAL ESTATE EQUITY MANAGEMENT

MARKETS OUTLOOK: JANUARY 2008

2008 promises to be one of the most interesting years in quite some time. We expect a great deal of complexity and challenge - and very interesting opportunities - for those of us in the investment management business. The fallout from the sub-prime crisis (and, more accurately, several years of easy credit and mis-priced risk) will continue to cascade through the global financial markets.

Oil prices, which hit the \$100 a barrel mark in the first few days of the year, and the moribund housing market, will provide a daily reminder of the pressure on the economy. The upcoming election, with no incumbent running and no clear front-runner for either party, will add an element of uncertainty regarding fiscal and tax policy (as well as the direction of the dollar). And continuing political unrest in the Middle East, Africa and Asia will make it hard to relax when reading the newspapers. Those are the challenges.

At the same time, the more volatile and messy the market environment, the greater the opportunity for careful, smart value investors. There will be mispriced assets and distress; and the lack of aggressive financing will mean fewer investors competing for opportunities. In fact, given the choice between the strong momentum of a year ago, which featured fully priced core assets and mountains of cheap debt, and today's illiquid uncertainty, we much prefer to be making new investments today.

That said, we will need to continue to differentiate between managers that are value-added in name only and those that truly have the skills to renovate and reposition properties. We will also need to be increasingly tactical in identifying pockets of distress and managers that can capitalize on these opportunities. In 2008, experience is likely to matter considerably more than in recent years, and we believe that the experience gained in prior cycles will help us quite a bit as we seek to identify attractive investments for our partners.

More detailed thoughts and expectations for 2008 are as follows:

The financial markets and the economy will remain challenging, but low interest rates should provide significant support. We expect:

- Illiquidity and choppiness. Financial markets will continue to deal with illiquidity and the re-pricing of risk. This process of marking-to-market mortgages, CDOs and other debt instruments will not happen quickly but rather will happen in installments over several quarters. Over-leverage or poor risk-pricing in prior acquisitions will continue to cause pain for those investors that stretched, and lenders will continue to be very cautious.
- Favorable and aggressive monetary policy. The Federal Reserve is likely to be more focused on growth (and the health of financial institutions' balance sheets) than on fighting inflation, which will tend to keep interest rates low and provide support for commercial property values.
- Slowing growth. The U.S. (and other developed countries in Europe and Asia) will deal with slowing growth. Within the U.S., some sub-markets will remain vibrant and healthy and others will feel the economic slowdown more acutely.



Existing real estate investments will transition from the recent “momentum” period to a more normal operating environment. This environment should include:

- Stable pricing. We expect commercial property yields to be relatively stable in 2008, but it may take some time before all players in the market adjust their views to accommodate the new pricing metrics from the second half of 2007.
- Making money the old fashioned way - earning it. Managers will stop “trading” properties and will focus on renovating properties, maintaining occupancy, and achieving rental growth - that is, fundamentals. There will be very few large portfolio sales and a historically small number of property sales overall.
- Slow-down in new development. The level of new supply in most markets, which had been accelerating prior to the sub-prime crisis, will be very modest in 2008 as construction lenders underwrite very cautiously.
- Mark-to-market of existing portfolios. Some private equity real estate funds will report unrealized losses in prior investments (in general, to reflect the change in market yields and not deteriorating fundamentals); those managers that were conservative in their historic marks may not need to make any valuation adjustments. A few of the mark-downs have already flowed through fund financial statements in the quarter ending September 30, 2007; more will likely appear in the year-end financial statements.

2008 is likely to be an excellent year for new commercial property investment. Specifically:

- Attractive property acquisition opportunities. We expect to see increasingly interesting opportunities to acquire under-performing infill properties across markets and property types. The lack of aggressive financing will keep highly leveraged buyers (who had been competing with our managers) out of the market and the general uncertainty may boost the risk premium paid to managers that can turn properties around. By definition, manager selection will be increasingly important, and market selection will matter as well, since any weakness in the economy is not likely to be evenly distributed.
- Distress and complexity will create opportunities to make cyclically attractive returns. We expect a steady flow of distressed/opportunistic situations. The largest volume of opportunities will likely continue to be in the residential and debt sectors, but we also expect to see recapitalization opportunities (both negotiated and involuntary) with over-leveraged borrowers on a broader basis.
- Liquidity will return to the market - cautiously. Moderate loan-to-value (“LTV”) financing will be increasingly available as lenders re-focus on new business; seasoned borrowers with strong property skills will have a significant advantage in obtaining new credit. High LTV mezzanine financing will only be available from distressed equity players at prohibitive pricing.

In summary, value-added and opportunistic commercial property investing will continue to be an attractive way to access the asset class. Managers with strong, proven value-added skills will have better access to capital and should be well positioned to execute on their strategies. There will continue to be a lot of distracting “noise” in the financial markets. In spite of the market noise, we will continue to focus on basic underwriting and manager evaluation, and look forward to what we believe will be a very interesting - and ultimately very profitable - year.