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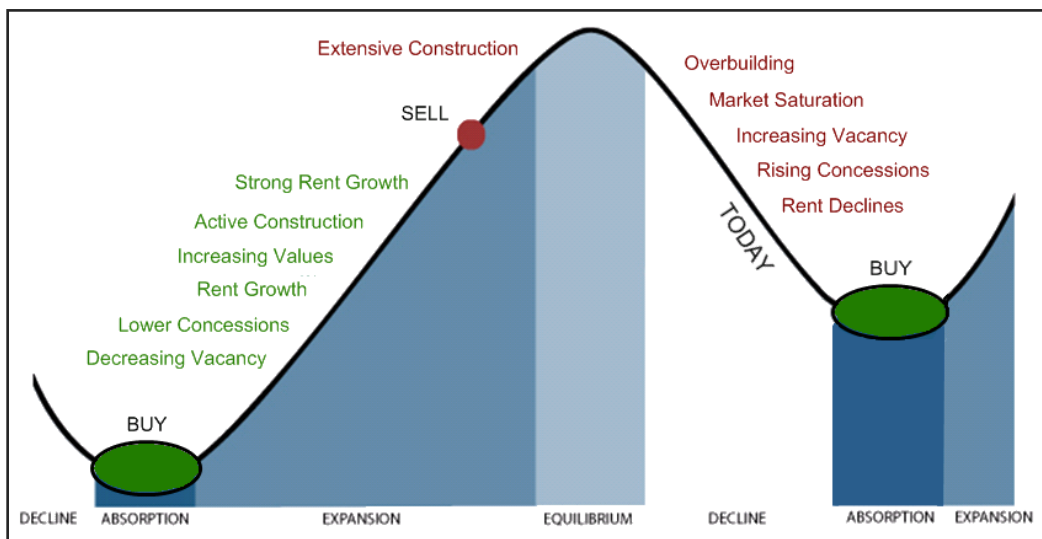
## Real Estate Investment in a Recession: Opportunity or Albatross?

Since our last market update, we have all watched the wheels come off the bus of our economy. Fortunately, it appears the doomsday scenarios of an endless economic freefall and a repeat of the great depression may have been avoided. There has been a substantial reduction in value of nearly every asset class - including real estate. We anticipate that it will likely take considerably longer for the economy to heal itself than it did to unravel, though not without creating significant investment opportunities along the way. It is the intent of this letter to focus on when attractive commercial real estate opportunities—and specifically apartment investment opportunities—will emerge. ***In short, we believe an extraordinary buying opportunity is at hand, brought on by a substantial decline in property revenues and a severe reduction of capital flowing into the commercial real estate market.***

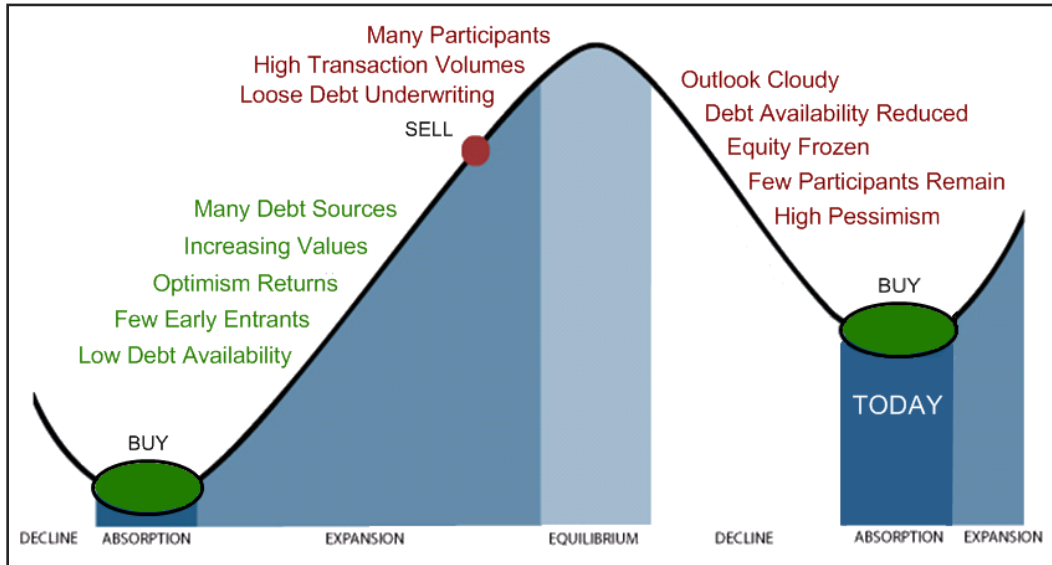
### Drivers of Real Estate Cycles

There are two primary groups of fundamentals that drive investment returns in real estate cycles. The first are operational fundamentals, which stem from the supply of and demand for real estate - in this case apartments. The second is the volume of capital flowing into real estate, both debt and equity. Operational fundamentals dictate how well a property will perform in terms of generating consistent cash flows for investors during the period of ownership, while it is capital flows that dictate the valuations given to those cash flows. Key indicators of operational health include occupancy rates, rent growth (or lack thereof), and the costs associated with operating these buildings. Key indicators of capital flows include number of market participants, loan underwriting standards, and transaction volumes. ***Very simply, the total return on any commercial real estate investment is greatest when operational fundamentals are strong during an asset's hold period, combined with strong capital flows at the point at which an asset is sold.***

### Real Estate Operational Fundamentals Cycle



## Real Estate Capital Flows Cycle



### Review of Last Cycle:

Let's start by looking back at our last cycle of 2001-2008 as a foundation for understanding where we are today. As a whole, it was typified by a traditional decline and rebound of operations. However, capital flows to real estate were increasing through much of the cycle, leading to moderate investment losses at its trough and explosive value increases during the recovery. In 2001-2003, most markets experienced the typical domino effect brought on by job losses, triggering increases in delinquency, fewer lease renewals, lower leasing traffic, lower occupancy, lower rental rates, higher advertising and increased turnover costs. All of these factors contributed to declining cash flows and declining values. In most cycles, this negative impact on values is amplified by over-construction of apartments. However, in the 2001-2003 period declining values were primarily amplified by the expansion of home ownership – an irregular phenomenon for a recessionary period. The resultant pain was felt first in high end Class-A apartment product, and trickled its way down to Class-B and Class-C product as reduced pricing drove increased competition. As operations stabilized, 2004-2005 brought large flows of capital into commercial real estate. Following on the growth in exotic securitized debt for residential real estate, lenders began providing more and cheaper debt to commercial projects with increasingly aggressive debt products. Finally, 2006-2007 saw many equity participants race to take advantage of increasing operational fundamentals, cheap capital, and a promise of a bright future. The combination led to the peak selling opportunity identified in both graphs above. This cycle came to abrupt halt with the start of the Credit Crisis in late 2007. The final blow came in late 2008, with the financial markets collapse that removed the last remaining optimism, as large job losses predictably followed.

### Today's Cycle and Outlook:

Over the past twelve months, operating fundamentals have deteriorated significantly in those markets that have seen continued job losses. This is evidenced by negative occupancy rates and falling rents. This correlation between job losses and operating fundamentals is fairly typical for an apartment cycle in a recession. And while by all measures this recession is more severe than most, the apartment market is fortunate this time around because the current supply of new apartments in most regions is relatively limited and is expected to dry up for the foreseeable future - due to an absence of construction financing.

Virtu expects the apartment market at large to continue to decline operationally for the next 12 to 18 months, how much will depend on the market and the asset quality (A, B, or C). Many markets may have already reached their operational lows (Phoenix, Las Vegas, parts of Colorado and Florida), while others (Seattle, Los Angeles, Austin, Dallas) may have further to fall. Similarly, Class-A product has seen the most dramatic early declines, with Class-B and Class-C likely to feel more over the next 12 to 18 months. Upcoming supply will continue to be constrained by deteriorating fundamentals and limited debt financing for new construction. This limited supply will be met with growing demand from a demographic influx of the baby boom echo (adult children of baby boomers) in their prime renting years, and an economy adding jobs again. *Looking forward, we anticipate this supply and demand imbalance to be in apartment owners' favor, and anticipate strong operational fundamentals to begin in 2011 and carry through to 2015.*

The apartment transaction market is in a virtual lockdown with volume off close to 90% from its highs. The debt market is constrained by limited financing options. The agencies (Freddie Mac and Fannie Mae) remain consistent providers of capital, but only to apartment investors. This has managed to maintain relative stability in the apartment market, whereas other commercial real estate asset classes do not have any low cost options. However, agency underwriting has tightened, limiting the amount of leverage available, and interest rates (currently around 5.8%) have risen modestly from their lows. Equity capital is limited and prone to uncertainty about the fundamentals of operations going forward, and therefore is being deployed sparingly. As a result, capitalization rates continue to rise and values continue to fall. We anticipate apartment values are off their highs by between 20% to 40% depending on locations and product type.

However, it appears the tide is changing in terms of transaction volume. The pressures of capital requirements for struggling assets, equity fund redemptions, and various bridge loan expirations are forcing more owners now to make the difficult decision to sell. In addition, values have fallen to a point where cash-on-cash yields are starting to become attractive enough to bring cautious equity off the sidelines. Transaction volumes will accelerate as debt expirations mount in 2010 through 2013. However, absorbing this massive amount of largely troubled debt will take time and capital flows to commercial real estate are likely not to keep pace with the number of assets needing to clear. During this period, value should remain under pressure despite improving operating fundamentals, offering excellent opportunities for well capitalized investors. *We expect low capital flows to persist until the improving operational trend becomes clear and most of the bad bank debt has worked its way through the financial system*

### **The Buying Opportunity**

After a two year hiatus from investing at any material level, Virtú intends to begin easing back into the market today- at the beginning of a new cycle, with select acquisitions of higher quality assets, conservatively underwritten to achieve returns in the mid teens. Virtú Investments believes apartment investment fundamentals today point to a market that is entering the pre-recovery stage. Most of the catastrophic risk has been mitigated through a combination of operational softness and re-pricing of the asset class in the transactional market. Today's market pricing of the asset class seems to us to be fair. It anticipates a slow recovery, and allows for solid cash flows 6%-10% to be achieved without improving operations. With conservative underwriting we expect properties to produce sound returns of 13%-15% with modest (65%) leverage with below average risk levels correlated to those returns. However, historically speaking, it has been at times like these that we have outperformed our projections, and we hope to be able to do the same again.

We will initially be focused on superior properties in strong locations, as our investment thesis remains that these properties will have seen most of their operational deterioration earlier in the cycle than much of the Class-B and Class-C product in more tertiary locations. We will selectively acquire these other asset classes (B&C), but only in highly opportunistic scenarios where we can underwrite further softening of operations and still model above average profits.

### **Conclusion**

Virtú Investments is excited that this most recent contraction in the apartment market has re-priced this exceptional asset class, allowing us to begin to acquire properties at the beginning of yet another cycle. To reiterate, today we believe that much of the catastrophic risk has been removed from the industry, and there is visibility to stabilization and improving operational fundamentals that should endure through the majority of the coming hold period. This operational recovery, in conjunction with a recovery of capital flows anticipated during our divestiture period should create excellent risk-adjusted returns.

### **Virtú Investments**

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