PACE PROPERTIES

PACE REALTY FUND II NEWSLETTER

The Role of Capital

August 28, 2009

This memo contains important information about the offering in the last section following some market observations below.

The Role of Capital in Real Estate Investment

On Wednesday, August 26th an article appeared in the Wall Street Journal with the headline, "REITs are poised to pick up the pieces." The central thesis is that private equity is struggling and REITs have shored up their balance sheets with new equity and debt. This strikes at the very nature of down markets—those with capital will have the opportunities to reap extraordinary returns.

The WSJ article generalizes saying that private funds are "gasping for money" to both bail out their existing problems (caused by over paying and over leveraging property purchases and development in recent years) and to try to put themselves in a position to be buyers of opportunity. Once again, those with capital will have the opportunities.

The article generalizes about private funds saying in the early 90's "most vanished from the scene" and by contrast many developers went public in that period raising money to be effective. The lesson—successful investors will adapt and adjust to achieve positive results in periods of change. Securing capital is part of that adaptation.

The period from 2004 through 2007 saw many private and public funds (and investors of all kinds) invested heavily in real estate forcing cap rates down—prices up. Like drunken sailors in port, they may have been to too prolific and profligate. We have always been discriminating buyers. We did not find much to buy in this period. It is hard to find value in periods of rapidly rising prices.

Many REITs have improved their balance sheets and staved off potential defaults on their credit facilities. Some sold property to do so. It is interesting that many of the REITs that took actions to dilute shareholders and increase liquidity did so at the strong urging of Marty Cohen and Bob Steers of Cohen and Steers, operators of several REIT mutual funds. Cohen and Steers were intimately familiar with the balance sheets of their portfolio companies. A successful new investor must look into an entity's existing balance sheet when considering an investment in that entity. It is not always easy to do.

A new entity with a clean balance sheet may be a more efficient way to invest. We would compare this to the case of a new bank versus a legacy bank. A new bank formed after the recent period of excess does not have the baggage of a loan portfolio with potential and realized problems. The new bank can operate more efficiently without spending staff time and money on problem loans, correcting compliance issues and workouts. The new bank should be more efficient and in better position to pursue new business. If this environment, characterized by a shrinking capacity (fewer banks, tighter credit) and more stringent underwriting, yields higher prices for money, the new bank should be in position to take advantage of those better margins and less competition.

So, it seems to us, if one is interested in taking advantage of the markets to buy value, one should try to do it without the burden of past mistakes and a diluted balance sheet.

Many people have told us that they are concerned about efficiency in their investment activity. One friend calls inefficiency, in the form of fees, corporate expense, etc., "friction." Friction is a countervailing force to efficiency. Most REITs have become large organizations with expense structures similar to many industrial corporations. This is "friction" just as excess staff dedicated to workouts and management of past mistakes is also. One should always look at efficiency in the investment vehicle that they are considering.

If you have any questions, please feel free to contact Larry Reed or Rob Sherwood. Thank you.