The 2009 Ernst & Young business risk report

Real estate

In collaboration with:

Ernst & Young
Quality In Everything We Do

Oxford Analytica

"Risk management is based on the notion that history repeats itself, but not quite."

Peter L. Bernstein

About this report

Ernst & Young continues to be heavily engaged around the world in seeking to identify leading practices in the area of risk management. Properly approached, the process of risk management can add value even if, fortunately, the feared events never happen. In working through scenarios and impact analysis, companies may find many opportunities to tighten processes and controls that can make them more agile and able to operate more effectively, in whatever market conditions arise.

Our work with companies around the world suggests that there is a body of leading risk management practice emerging, but that many companies are still doing too little in this area. Our research has shown that, while strategic risks have become more important, companies have been focusing on the easier-to-manage areas of operational risks. In looking to general practice, the implications for different sectors can be blurred. One person's challenge is frequently someone else's market opportunity. Even within each sector, the risks for each company may vary. Risk management must be carried out at the company level.

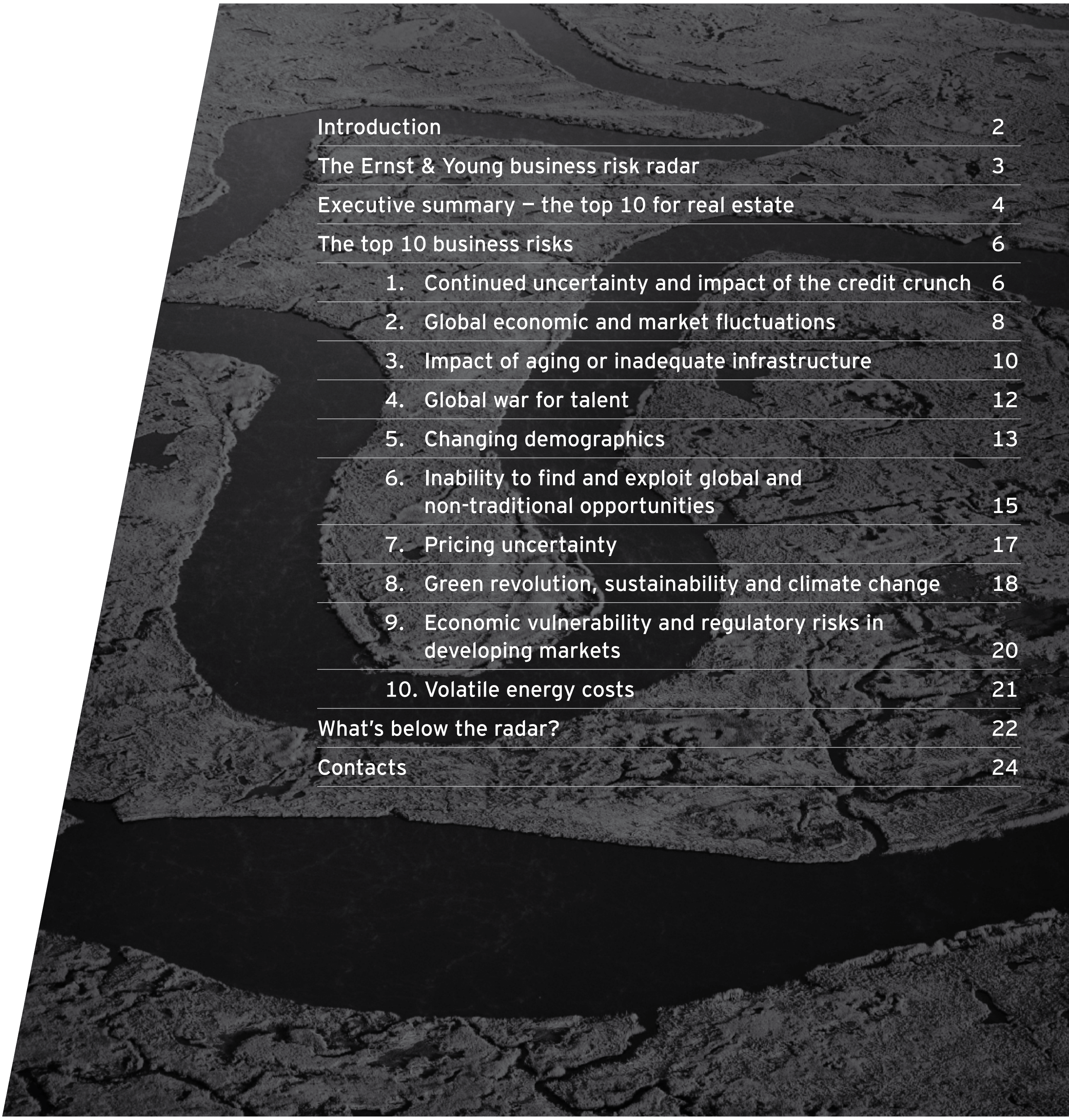
We have consulted widely but this is not an exhaustive list of risks. Inevitably it is a snapshot of the risks we see at this time. We encourage you to read this report in a questioning manner. Do you agree with the risks? How do they impact you? We hope that some of the risks identified surprise you and some of the weightings that we attached to them in the rankings differ from those that you would apply. You should have your own equivalent of a risk radar and your own ongoing dialogue around this, within your own organization.

We believe that company leadership must:

- Conduct an annual risk assessment that defines key risks and weights probability and impact on business drivers. The risks in this report can provide the start of that process.
- Assess risks beyond financial and regulatory risk to consider the wider environment in which the organization operates and the full extent of its operations.
- Conduct scenario planning for the major risks that they identify and develop a number of operational responses (possibly as part of the planning cycle).
- Evaluate the organization's ability to manage the risks that they identify – in particular ensure that the risk management processes are linked to the actual risks that the business faces.
- Have effective monitoring and controls processes to give both earlier warning and improved ability to respond.
- Keep an open mind about where risks can come from.

Sometimes, of course, the risks that we fear actually come to pass. Few of the risks that have devastated the financial services sector and badly hurt the wider economy were unpredictable – economic bubbles generally burst. It is now, in the hardest of times, when seeking to gain opportunity from adversity, that we will see the evidence of effective risk management and those companies which mastered it.

Contents



Introduction

Howard Roth, *Global & Americas Real Estate leader*

Globalization has taken on new meaning as the US credit crisis continues to ripple across economies and real estate markets around the world.

Falling housing prices, record numbers of home foreclosures and further deterioration in the commercial markets continue to weigh heavily on the industry. In addition, the continued uncertainty about the availability of credit and the long-term implications of the credit crunch have resulted in many real estate owners and investors delaying or canceling real estate projects and investments in an effort to preserve capital and weather the storm.

The real estate industry as a whole is focused on simplicity, transparency and quality deals. There is a lot of capital on the sidelines waiting to take advantage of distressed real estate opportunities when the time is right. At the same time, many investors and lenders are becoming increasingly focused on getting back to basics. A structured, comprehensive due diligence program will be more important than ever as buyers and sellers evaluate their opportunities.

Nobody knows when the real estate markets will bottom out. However, many companies are proactively looking for ways to effectively manage risk and streamline operations so they can hit the ground running when markets begin to stabilize.

To help readers navigate through these precarious times, we interviewed senior, global real estate industry leaders from Ernst & Young — along with leading real estate industry executives and industry analysts. Together, we have identified and ranked the top 10 business risks affecting the real estate industry.

In the following report, we comment on each of the top 10 risks, and provide industry insight on how to respond to these trends. We also comment on a number of risks that currently fall "below the radar," but could emerge as top risks in the future.

I would like to thank all of our panelists for their valuable time and insights especially Leanne Lachman, President of Lachman Associates and Peter Linneman, Principal of Linneman Associated, and Professor of Real Estate, the Wharton School of the University of Pennsylvania. This is a dialogue that definitely needs to continue as we move forward through these difficult times. I sincerely hope you find this report insightful and thought provoking.

Kind regards,

The Ernst & Young business risk radar

Risk weighting and risk prioritization

Phase 1:

- We interviewed commentators and academics representing the real estate sector, asking each interviewee to identify the top business risks for 2009. We asked the panelists to focus on risks for the leading global firms in the real estate sector. We also asked each panelist to provide commentary on why each risk was important, how each risk had changed since last year, and which of a company's value drivers each risk might impact.
- Based on these interviews we drew up a long list of risks for the real estate sector.

Phase 2:

- In order to prioritize the top risks for the sector, we interviewed panels of sector professionals. The composition of the panels varied and included CEOs, strategy planning executives, analysts, journalists in trade publications, advisors and our own Ernst & Young practice professionals. We asked each panelist to provide their own ranking of the top 10 risks for their sector, as well as up to five "below the radar" risks that may emerge to threaten the performance of leading firms in the years ahead. The panelists' ratings were aggregated to select the final top 10 risks for real estate companies.

The Ernst & Young risk radar is a simple device that allows us to present a snapshot of the top 10 business risks for a company or a sector.

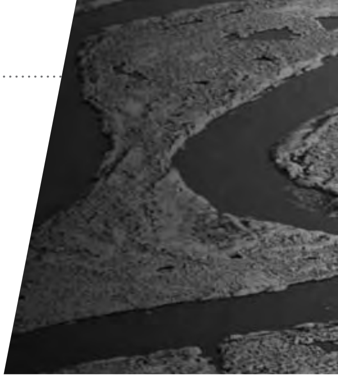
The risks at the center of the radar are those that the analysts we interviewed thought would pose the greatest challenge to the leading global firms in the real estate sector in the year ahead.

The radar is divided into four sections that correspond to the Ernst & Young Risk Universe™ model. *Compliance* threats originate in politics, law, regulation or corporate governance. *Financial* threats stem from volatility in markets and the real economy. *Strategic* threats are related to customers, competitors and investors. Lastly, *Operational* threats impact the processes, systems, people and overall value chain of a business.

The top 10 business risks for real estate

Key to symbols

- Up from 2008
- Down from 2008
- New entry



Executive summary – the top 10 for real estate

The top 10

Ranking from 2008 in brackets

1. Continued uncertainty and impact of the credit crunch (New)
2. Global economic and market fluctuations (7)
3. Impact of aging or inadequate infrastructure (6)
4. Global war for talent (14)
5. Changing demographics (13)
6. Inability to find and exploit global and non-traditional opportunities (4)
7. Pricing uncertainty (New)
8. Green revolution, sustainability and climate change (9)
9. Economic vulnerability and regulatory risks in developing markets (8)
10. Volatile energy costs (New)

Aggregating our interview results worldwide, the top 10 business risks for multinational firms that are leaders in the real estate sector are:

1 Continued uncertainty and impact of the credit crunch

Last year's top risk, a disorderly shakeout of real estate finance, has materialized. The real estate sector has felt the tightening conditions in credit markets perhaps more than any other industry. (New this year.)

2 Global economic and market fluctuations

Not unexpectedly, analysts are deeply concerned that several economic and market shocks have hit simultaneously. Hard hit areas, such as finance, hospitality and homebuilding, are responding to the risk through consolidation and reductions of their cost bases. However, for some, these shocks can create opportunities. (Rising from Number 7.)

3 Impact of aging or inadequate infrastructure

The extent to which countries invest in infrastructure and the type of infrastructure they need varies as countries strive to keep pace with their economies and remain globally competitive. Many mature markets face an acute need for substantial infrastructure investments, which may be supported by the various government economic stimulus packages. (Rising from Number 6.)

4 Global war for talent

As one analyst put it, real estate companies "are way behind the curve. They don't have good hiring and retention policies. Some companies recognize the problem but are not really addressing the issue in a structured way." (Rising from Number 14.)

5 Changing demographics

Shifting demographics will determine what will be built, where it will be built and how it will be funded. Acquiring a comprehensive understanding of demographics is crucial for companies seeking to exploit emerging trends. This can include relocating workplaces to key developing regions. (Rising from Number 13.)

6 Inability to find and exploit global and non-traditional opportunities

In the current financial climate, companies need to be quick in responding to shifting wealth and have the confidence to move into new markets while taking advantage of new investment prospects. (Falling from Number 4.)

7 Pricing uncertainty

While real estate value estimation is inherently uncertain, the challenge has increased dramatically in light of international market volatility. Increased pricing uncertainty tends to make investors uncomfortable with entering into new transactions. (New this year.)

8 Green revolution, sustainability and climate change

The green agenda has increased in importance for a number of reasons. These include mounting political momentum and regulation (particularly on carbon emissions), increasing energy and raw materials costs, and the potential damage to reputation from appearing to be environmentally irresponsible. (Rising from Number 9.)

9 Economic vulnerability and regulatory risks in developing markets

While the US and Europe have led the volatility in global markets, emerging economies are being increasingly affected by the downturn. (Falling from Number 8.)

10 Volatile energy costs

The challenge of volatile utility costs also presents real estate owners/developers, users and investors with an opportunity to re-examine current practices, and to implement response plans that could put them ahead of their competitors. (New this year.)

The top 10 business risks

1 Continued uncertainty and impact of the credit crunch

The continued uncertainty and impact of the credit crunch is the greatest strategic risk facing the real estate sector in 2009. Last year's number one risk, a disorderly shakeout of real estate finance, clearly has materialized. Today, real estate companies are grappling with the continued turmoil that has resulted from the credit crunch. When the markets will hit bottom, and how the after-effects of the crisis will reshape the real estate industry, is still unknown.

It is fair to say that the global impact of the subprime meltdown exceeded most expectations. The restrictions on availability of credit and the short-term inability to deploy capital at acceptable levels of return have paralyzed the transaction sector of the real estate industry. Michael Lucki, Ernst & Young Global Infrastructure and Construction leader, commented, "The only lending being done today is on deals with 50% loan to value and at rates that are 200 to 400 basis points higher than six months ago, whereas towards the end of 2007 most loans were at 80% to 90% loan to value."

There are also more fundamental issues. In the US, the top two layers of securitization – collateralized debt obligations (CDOs) and structured investment vehicles (SIVs) – have evaporated and may not return for years. One analyst argued that commercial real estate securitization must now be restructured in a way that "probably [forces] primary lenders to retain part of the overall risk." Global capital is out there, but lenders are picking spots carefully.

The real estate sector has felt the tightening conditions in credit markets perhaps more than any other sector due to its heavy reliance on capital. The requirements for equity on construction loans are increasingly demanding, resulting in the reduced availability of financing for both local and national developers. Permanent loans on properties also have declined dramatically, with current availability being only one-tenth of what it used to be, according to one analyst.

Financial conditions for real estate projects are undoubtedly worsening and the current financial markets landscape is expected to persist for the next couple of years. The reduction in lending and the decline in transactions and sales have led to the stagnation and cancellation of many projects. Another analyst wrote, "The issue is that the bad debts that have been taken on are so large that they are sounding the death knell to a large number of companies." Real estate values are falling and there is a huge oversupply of property in some markets. While this will affect the growth of both developers and construction companies, it has also put the future prosperity of the entire industry at stake.

Steps companies can take to respond to this risk

- Conducting appropriate due diligence of investment activity to determine if real estate assets are performing as expected. A rigorous approach to due diligence will help companies understand whether a specific fund or investment is likely to meet strategic objectives within an acceptable level of risk tolerance.
- Developing strategies and positioning the entity to take advantage of distressed assets and debt situations or to acquire weaker companies.
- Getting your "house" in order. Assess business processes to better understand and enhance the organization's operational efficiency.
- Adopting a systematic approach to managing risk, cutting costs, improving cash management and enhancing lender relationships.
- Modifying future business plans to obtain cash on the balance sheet and trade on higher multiples. i.e., adopt a capital-oriented business plan that focuses on obtaining and preserving cash.

Navigating the credit crunch

A **Michael Straneva,** *Ernst & Young*

Mike is the Americas Director of Ernst & Young's Transaction Real Estate group. With more than 25 years of experience, Mike focuses on real estate appraisals and valuation, transaction due diligence, portfolio analyses and structuring, project feasibility and market analyses, and litigation support services.

B **Richard Sinkuler,** *Ernst & Young*

Rick is the Global Markets leader for the Real Estate sector group. He has more than 20 years of real estate industry experience, including valuation, market analysis, financial restructuring, litigation support and transaction due diligence work.

The economic landscape

The world economy has entered some new and precarious territory. No region will be fully immune. The fallout from the US credit crisis has spread to housing markets around the world. Global house prices fell for the first time on record toward the end of 2008, underlining the extent of the downturn. Fears about rising default rates and declining property values, which engulfed the home mortgage market at the start of the credit crisis, are spreading to the commercial real estate market; many feel the worst is yet to come with respect to commercial real estate values.

There is no question that the global impact of the subprime meltdown exceeded most expectations. Debt structures and investment vehicles have become increasingly complex. In addition, a number of complicated "alternative asset" classes, such as private equity and infrastructure, have emerged.

The problem associated with some of the complex securities and debt structures is that we don't fully know what all the risks are. This has created an environment of uncertainty, which has virtually brought lending to a standstill. The restrictions on the availability of credit and the short-term inability to deploy capital at acceptable levels of return have paralyzed the transaction sector – as transaction volume around the world has skidded to a halt.

No matter where you reside, world economies are finding out that they are much more highly correlated to each other than originally anticipated – particularly during tough economic times. Other global trends are putting additional pressure on businesses and consumers, including rising energy costs, globalization, increased regulation and risk of political and social unrest. As a result, consumers have retreated. Global economic forecasters have revised their GDP estimates downward. Governments are now working together to restore confidence and get consumers and businesses moving again.

Reality check survey

Ernst & Young and GlobeSt.com, an Incisive Media Website, polled clients and subscribers (15-17 October, 2008) to take their pulse on a number of significant real estate issues now in play. More than 2,300 global real estate executives responded.

The survey indicated that there will be more pain ahead, and that industry professionals across the board are going to feel it. Although the majority of respondents believed that the credit markets will begin to emerge during 2009, the implication is that the process of restoration could take months longer. Respondents expected commercial real estate values to decline – by perhaps as much as 20% or more but at least by 10%.

Implications

The current crisis is negatively impacting residential and commercial asset values, company liquidity, and availability of credit. Everyone is trying to conserve capital. On the positive side, companies are also taking advantage of opportunities that exist. When things are going really well, it tends to mask organizational inefficiencies, but now smart companies are asking how they can eliminate the duplications and inefficiencies inherited when growth was strong. As things turn around, they can then be in a position to hit the ground running.

With unprecedented challenges, come historical opportunities ... for some. Smart lenders may be looking to move real estate related assets off their books very quickly while forward-thinking companies will develop strategies to take advantage of distressed asset and debt situations. Overall, there may be a lot of capital waiting to deploy when the time is right. Consolidation will likely take place as the industry reshapes itself in response to changing global economic and market conditions. Whether you're an owner, investor or developer, now is the time to get your house in order.

> "Most of our clients with portfolios of real estate assets and ongoing capital programs are making tough decisions in terms of rationalization or cost reduction to stay competitive."

2 Global economic and market fluctuations

This risk has risen sharply, from seventh place in our 2008 report, to the second greatest risk facing the industry this year. Many of this risk's drivers are directly related to the ongoing credit crunch and consequential financial volatility.

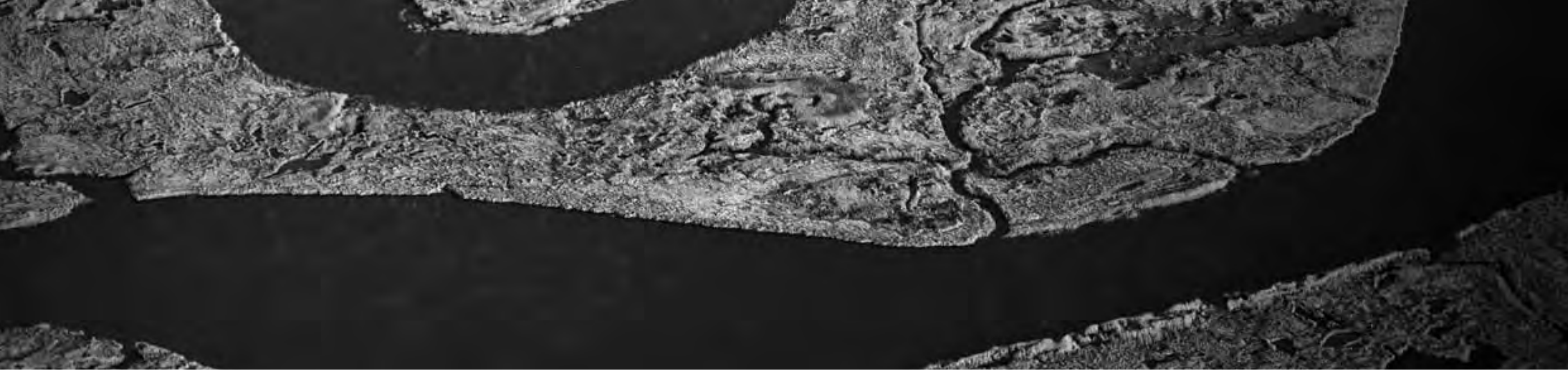
Not unexpectedly, a number of analysts are concerned that several economic and market shocks have hit simultaneously. Leanne Lachman, Founder and President of Lachman Associates, wrote that "the combination of high energy costs, lack of food and/or price increases, home value declines, stock market deterioration, and credit compression is extremely worrisome."

In hard-hit areas, such as finance, construction and hospitality, companies are responding to the risk through consolidation and reductions of their cost bases. With regard to consolidation, many companies will sell — inevitably at low prices in order to survive — and conservative strategies will be the order of the day for those left in the market. With revenues effectively fixed, the only way to improve returns is to reduce costs.

According to one Ernst & Young analyst, the impact of the global economic situation and market fluctuations is reflected primarily in the increasing challenges to asset and capital management. As a result, what we are seeing is a correction in valuation within the market. Short-term, reduced rents are affecting the profitability of companies, while economic and market fluctuations are likely to reduce long-term investment in the sector. Malcolm Bairstow, Global leader, Ernst & Young Real Estate Advisory Services, noted that "Most of our clients with portfolios of real estate assets and ongoing capital programs are making tough decisions in terms of rationalization or cost reduction to stay competitive."

Steps companies can take to respond to this risk

- Structuring transactions to take advantage of tax and accounting regulatory environment.
- Implementing a comprehensive due-diligence process.
- Selecting the right local partners.
- Knowing the market and understanding current and future demographic trends, culture and related risks.



Back to basics

Mark Grinis, *Ernst & Young*

Mark is in the Real Estate group in the New York office. He previously managed Ernst & Young's Asia Pacific Financial Services practice. During his 25 years with Ernst & Young, he has worked extensively with distressed assets. Before establishing the Asia practice, Mark was a key contributor to the US government's efforts to strengthen the financial sector following the US savings and loan crisis.

In 2008 we witnessed considerable economic uncertainty in the real estate sector. Home values plummeted and there was a record inventory of unsold homes. At the same time, credit markets seized as investors stopped purchasing securities. Consumer confidence was at a 16-year low.

It was not all bad news. A recent poll by Ernst & Young and GlobeSt.com showed that while people expect real estate to be in for a tough time (85% said they expect real estate values to fall over the next year), they were also on the lookout for opportunities (73% of investors said they were either in the market now looking for deals or would be in the first half of 2009).

While each economic cycle brings its own particular challenges, experience from prior shakeouts can provide a valuable roadmap on how to identify and take advantage of any opportunities that exist in the current turmoil. Ernst & Young asked a number of senior real estate professionals who have lived through previous major real estate downturns for a few tips and suggestions on how to do just that. The resounding message was to "get back to basics." Many of these things seem straightforward but in climbing markets, it is amazing how often the simple things are ignored. Focusing on the simple things may help you survive during a downturn.

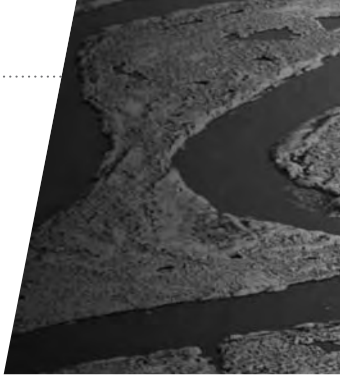
Here are their top five suggestions of things to focus on to make sure you are well positioned to react to whatever the crisis brings:

- **Understand the contracted cash flows.** Understanding the contracted cash flows attached to any portfolio is critical.
- **Understand the credit profile of the current tenants.** Contracted rents are one thing, ensuring the tenant is able to pay is another.
- **Understand the operational efficiency of the portfolio.** No different from any other economic downturn, being able to manage costs is an important factor.
- **Understand the capital expenditure requirements.** With credit markets not functioning, being able to understand and manage big ticket capital items is an important part of cash flow management.
- **Understand the drivers behind valuation estimates.** Discount rates and capitalization rates are key drivers in the determination of real estate values, but it is important to understand the other factors that could be affected in a slowing economy.

In a recent interview with GlobeSt.com, Rick Sinkuler, Ernst & Young's Global Markets leader for the real estate practice in New York, echoed the same message. "We're trying to help clients understand that it's really about getting back to basics. By that I mean a number of clients are going to be in a position to either buy or sell assets, and it's very important that buyers and sellers understand what they have. The fundamentals have often been masked by complex securities wrappers, and it's important to get beneath those and start to peel them back to understand the cash flows, the underlying assumptions and the markets those assets operate in. Because when you peel it all back, you really get down to the real estate. Transparency is key, and the more you can do to restore confidence in whatever you're buying or selling, the better off your position will be."

As with most risks, the recent economic downturn has been accompanied by opportunities for many. For real estate players, the time to act is now. Fundamental back to the basics real estate analysis is going to be critical to supporting transactions when credit markets begin to open up.

"It is understood that the consequences of not renewing aging infrastructure or building up new systems are likely to be significant."



3 Impact of aging or inadequate infrastructure

A new entrant to the list this year is aging or inadequate infrastructure – the metamorphosis of last year's sixth risk, which focused on challenges to companies undertaking infrastructure projects. Owing to the inaccessibility of credit and the skyrocketing costs of materials needed in construction, infrastructure budgets have tightened and the implementation of many new initiatives has been delayed or canceled. At the same time, the need to expand, renew and maintain infrastructure is greater than ever. A combination of these factors has elevated the infrastructure risk three places since the 2008 report.

The extent to which countries invest in infrastructure and the type of infrastructure they need varies regionally. China and India have invested considerably over the last decade – mainly in "greenfield" projects – to keep pace with their growing economies. In many mature markets, "infrastructure investment has almost come to a halt," noted one analyst. As a result, many Western countries now face an acute need for substantial infrastructure investments, primarily in "brownfield" projects. As one analyst put it, "The US is [now] showing its cracks." However, the capital required may be harder to come by due to the economic downturn.

It appears that a primary source of infrastructure funding will come from governments. With one eye turned towards keeping their economies on track, and the other trained on the impact of the global economic downturn, many governments have announced significant injections of capital spending on infrastructure projects. For example, China announced a four trillion yuan (US$586 billion) stimulus package, the largest in the country's history, which is focused primarily on infrastructure spending. Part of US President Obama's US$825 billion stimulus package is also focused on infrastructure investment.

It is understood that the consequences of not renewing aging infrastructure or building up new systems are likely to be significant. In some countries, we already are seeing salinity and water quality reaching the point where there will be negative consequences to health. In a similar sense, inadequate infrastructure will affect the valuations of properties and real estate developments. Real estate value is determined by location. Surrounding infrastructure – such as transport connections, schools and hospitals – are essential to a property's attractiveness in the market.

Steps companies can take to respond to this risk

- Promoting private and public partnerships (PPPs). It is a common misperception that partially privatizing infrastructure projects will lead to job losses or irresponsible management. Real estate players need to be proactive in helping to inform and educate politicians and unions about the benefits of PPPs.
- Evaluating alternative financial and tax structures.
- Developing strong relationships and aligning with potential sources of funding.
- Bringing infrastructure into the development and construction planning process. Whether a company is building a hotel, warehouse or hospital, infrastructure must always be a part of it.

The growing need for P3s

Michael Lucki, *Ernst & Young*

Mike is Ernst & Young's Global Infrastructure and Construction leader. He is recognized for his knowledge of strategic planning, capital market transactions, due diligence and strategic issues related to infrastructure transactions and acquisitions of construction companies.

A country's competitive advantage

Today the need to invest in infrastructure is greater than ever. However, finding ways to fund projects continues to be a major challenge. Infrastructure encompasses a broad range of assets. It includes not only transportation infrastructure such as roads, airports and ports, but also energy and utilities, communications and social infrastructure such as schools, universities and hospitals.

There are four stages of the infrastructure lifecycle that describe where countries stand in terms of general quality, condition and level of investment. These are inadequate investment, retooling and revamping, growth and development, and coasting on prosperity. While Russia, Brazil and Mexico can be categorized under inadequate investment, Germany and the UK are retooling and revamping their infrastructure. Growth and development is taking place in countries such as China, India and the United Arab Emirates. Finally, we see Canada, Australia and the US coasting on prosperity.

It is becoming increasingly clear that infrastructure investment has come to a halt in a number of western countries, including the US. These countries are now experiencing stagnated or declining economic growth. At the same time, we're seeing China's economy prospering, relatively speaking, following intensive investment in infrastructure over the last decade.

Efficient and reliable infrastructure is a prerequisite for economic growth and is one factor that gives one country a competitive advantage over another. If a country wants to be competitive in today's world, it needs to invest in its infrastructure.

Challenges facing the US

There is general agreement that the quality of infrastructure in the US is deteriorating, posing potential risks to both economic growth and human health. The US has no high-speed trains; many US airports operate at near capacity and flight delays cost over US$15 billion annually in lost productivity. Since 1980, vehicle miles traveled have increased 95% while road capacity increased only by 4%. Moreover, over 25% of bridges around the country are structurally deficient or obsolete as demonstrated by the collapse of the I-35W bridge in Minneapolis, Minnesota in late 2007.

The global downturn however, might prove a driver for increased infrastructure investment. President Obama pledged to create millions of jobs through "the single largest new investment in US national infrastructure since the creation of the federal highway system in the 1950s." While the stimulus package that was just passed does not provide as much infrastructure spending as hoped, significant infrastructure investment is anticipated.

The global downturn aside, this level of investment is badly needed as the US population continues to grow. By 2040 forecasters predict that the US population will grow by 100 million. The bi-partisan Congressional Commission has recommended spending US$225 billion annually for transport infrastructure for the next 50 years. But only 40% of the annual requirement is currently spent in the US. Where will the additional money come from?

Public private partnerships (P3s)

To meet growing infrastructure investment demands, we are seeing an increase in projects funded by so-called public private partnerships (P3s). Australia, Canada and the UK are particularly advanced in using the P3 concept. P3 solutions provide an avenue for much needed investment into necessary infrastructure outside of a government budget. However, the private sector is not prepared to assume all the risks for an infrastructure project when the government wants to control, or strongly influence, factors that determine whether the project will be a success. The UK, Canadian and Australian governments, and certain BRIC countries, have largely addressed this issue of risk allocation, and could serve as models to resolve this issue in the US.

Source: Urban Land Institute/Ernst & Young, *Infrastructure 2008: A competitive advantage*

"Be prepared to recruit when the right talent comes along instead of waiting until a position needs to be filled."

4 Global war for talent

The strategic challenge of finding and retaining talent has risen sharply since the 2008 report when it was considered a below-the-radar threat. This is due to a combination of the absolute decline in the global working population and a relative decline in the industry's overall workforce. As one US-based analyst put it, real estate companies "are way behind the curve. They don't have good hiring and retention policies. Some companies recognize the problem but are not really addressing the issue in a structured way."

In addition to the aging global population and the decline in the overall working population, there is a relative decline in those who want to work in real estate and construction. One analyst noted that the labor force is rapidly declining on site. As a result, employees are sometimes either promoted too quickly or do not have the skills to do their jobs effectively. The decline in the quantity of labor available affects the quality of people working in the sector.

A number of the analysts we spoke to felt that due to the credit crisis, this risk's relevance in the near term had lessened somewhat, partly because the pursuit of foreign transactions in emerging markets is likely to be delayed for several years. "The recent economic downturn may soften the demand for talent and create opportunities for those organizations in a position to invest," wrote one Ernst & Young analyst.

But as the world's population continues to age, the real estate industry is likely to see the impact of a lack of talent on long-term growth. The global war for talent is likely to be a perpetual issue that will accelerate as the post-World War II baby boomers, born between 1946 and 1964, begin to retire. At the executive level, many companies are now sending their most talented people overseas to compensate for the added challenges of operating on an international scale. Companies that do not respond proactively to this issue are likely to see the quality of their employees begin to decline.

Steps companies can take to respond to this risk

- Planning strategically with respect to future human resource needs. Given the market downturn, there may be many opportunities for strategic hiring for companies with the resources to invest. Be prepared to recruit when the right talent comes along instead of waiting until a position needs to be filled.
- Implementing leading practices in recruiting, retention and compensation to help obtain and keep the right people.
- Being people-focused (respecting and representing diversity in the workplace), being growth-friendly (your company must be seen as a starting point instead of a stopping point), engaging in training initiatives, having a flexible workplace and communicating directly with your employees.
- Assessing the cost of potential redundancies, pension funding and labor regulations.
- Keeping open and honest lines of communication is more important than ever.

5 Changing demographics

Changing demographics constitute another risk that has leapt from below the radar into the top 10 for 2009. Although demographic analysis and forecasting is often seen as a natural part of the real estate industry — and demographic shifts present an opportunity for many — analysts felt that demographic issues have become much more pressing this year. They pointed to the aging population in the West, particularly in Europe, and the rise of the middle class in many developing countries. Shifting demographics will determine what will be built, where it will be built and how it will be funded.

Many developing countries have experienced rapid economic growth, which is leading to the rise of a middle class and creating new real estate needs. Despite the slowdown in GDP growth brought on by the global downturn, a growing middle class will lead to demands for basic services, including education; create demand for a leisure and tourism infrastructure; and strain the ability of countries to make more development-oriented investments. However, the importance of raw demographics should not be overlooked. "Why people are interested in medium- to long-term investments in Russia, [where] population is declining by one million people a year, is beyond me," one analyst commented.

By contrast, Europe's aging population is creating a risk of oversupply of residential homes and offices. Yet many analysts noted that this aging population will lead to increases in leisure activities and many aspects of the medical industry, which will require additional real estate space.

At a more fundamental level, demographic shifts continue to be one of the most important drivers of change in macro-economic trends for the medium- to long-term. Trends can differ quite significantly depending on the region. Geographic diversification is a critical competency for managing this risk.

Steps companies can take to respond to this risk

- Acquiring a comprehensive understanding of demographics in order to exploit current and future emerging trends. This can include relocating workplaces to key developing regions and recruiting talent from migrant populations.
- Linking strategic business growth plans to market demographics.

"Shifting demographics will determine what will be built, where it will be built and how it will be funded."

Changing demographics

M. Leanne Lachman, *President of Lachman Associates*

M. Leanne Lachman is President of Lachman Associates, a real estate consulting firm, Lachman is also an Executive-in-Residence at Columbia Business School.

The real estate industry constantly faces demographic changes that drive shifts in demand for all property types. At present, a number of global trends are particularly notable.

Aging

Today's single most dramatic trend is the aging of the world's population. From a real estate development standpoint, retirement housing is one of the most promising land uses of the 21st century. Although demand for assisted living and nursing homes in Europe is immediate, the US and Canada will not see a sharp increase in retirement housing demand for 18 to 20 years – when the Baby Boomers turn 80.

In 2006, almost 500 million people worldwide were 65 and older. By 2030, that total will rise to one billion – one in every eight people on earth. The most rapid increases are occurring in developing countries, which will see a jump of 140% in their 65 and older population by 2030. Because creation and funding of retirement systems is lagging behind demographic change, many countries will become old before they're rich.

Population growth

The world's population growth will occur almost exclusively in developing countries while mature economies face stagnation or actual decline. There are six exceptions: the US, Canada, the UK, Ireland, Australia and New Zealand will all experience population growth, thanks largely to their immigration-friendly policies. Real estate demand will remain vibrant in these six nations.

The most significant decline in population will occur in Eastern Europe and Russia, with the latter likely to lose one million people annually over the next 25 years. Twelve of the 15 countries with the world's lowest fertility rates are in Europe – mainly in the East but also including Germany and Spain.

Stagnant European property market

Europe will be the only continent with a declining population over the next 25 years; and with an aging population, Europe's labor force will also shrink. Together, these demographics will reduce net demand for real estate. Most of Europe will generate only replacement demand for the foreseeable future. "Replacement demand" means that each new building brought to market must be accompanied by destruction of a building of almost equal quality in order to maintain the same net supply. Replacement need becomes the only justification for new construction. If development exceeds new demand, vacancy rates will rise, causing rents and prices to fall.

Urbanization and rising middle classes

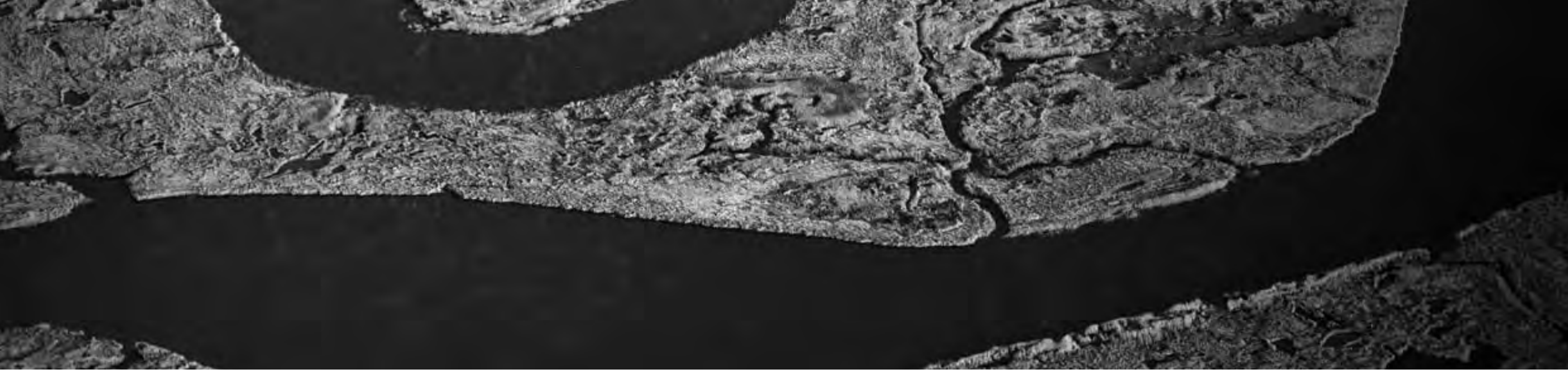
We have just passed the crossover point where the world's urban population exceeds rural dwellers. Virtually all the net population gain between now and 2050 will occur in urban areas of developing countries. Emerging markets in Latin America, Asia, the Middle East, and Africa – where growth in population and households will number in the billions – will need vast quantities of residential, retail, office, logistics, and hotel properties.

As their middle classes grow by tens of millions, countries like Mexico, India, Brazil and China have voracious appetites for contemporary real estate development, as well as roads, ports, sewage treatment plants, schools and other infrastructure. The deepest demand will be for convenience retail centers, budget hotels to serve domestic travellers, and workforce housing.

Looking ahead

As the real estate industry goes global, it's important to invest with the demographics, not against them. Go where demand is strongest – away from Europe and toward places like Mexico, Brazil, India and Turkey that offer strong potential from expanding moderate and middle classes. And don't ignore the six Anglo-American nations with continuing growth.

For more on this subject, see M. Leanne Lachman and Deborah L. Brett, *Global Demographics 2008: Shaping Real Estate's Future*. Urban Land Institute, Washington, D.C. 2007 (www.uli.org)



6 Inability to find and exploit global and non-traditional opportunities

As the global distribution of wealth and economic activity shifts, the inability to identify and exploit global and non-traditional real estate opportunities continues to pose a significant strategic challenge for the real estate industry. We see many companies globalizing their businesses through the use of joint ventures with local partners, and consolidation has created larger, international players. Uniform accounting standards have helped facilitate globalization by providing a common framework for evaluating investments.

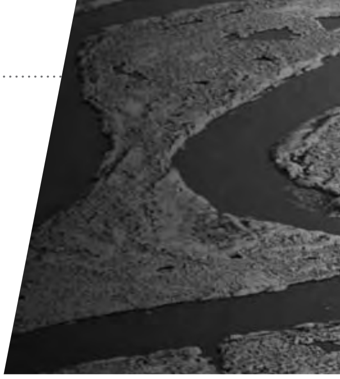
In the current financial climate, companies need to quickly respond to shifting wealth and have the confidence to move into new markets to take advantage of new investment prospects. As one Ernst & Young analyst put it, "With the shift of economic power moving East, and the acceleration of this effect caused by the current turmoil in the financial markets, companies need to be fleet of foot to a greater extent than ever before." Leanne Lachman argued that so much money has flowed to Asia in recent years; fundraising will now focus on Latin America.

Failing to move with the global economy and exploit non-traditional opportunities is likely to affect the growth of a company's revenues and market share. In addition to the competitive challenge of missing these opportunities, going global and tapping into non-traditional opportunities creates new risks. It is important that companies have an adequate understanding of the market in which they operate and find the right local partner and talent. Companies must be aware of issues such as competition from local players, cultural differences and more practical aspects such as utilities, labor, transportation and infrastructure. In non-traditional asset classes, where there is an operating company, investors increasingly are required to manage not just the real estate risk but also the risk of the business itself. In infrastructure, in addition to the challenges of project management, investors are realizing that risk and returns vary depending on where you are in the project lifecycle.

Steps companies can take to respond to this risk

- Continuing to globalize the business through establishing strategic alliances with experienced players that have a local market presence.
- Ensuring that you will be able to attract and recruit skilled local talent. There is now greater competition in emerging markets from local companies seeking to employ top home-grown talent.
- Making the fundamental organizational changes necessary to handle non-traditional investments. With different risks will come different individuals to manage them, and some companies will need to undergo cultural change to manage new business areas effectively.

“Sovereign wealth funds remain well-positioned to weather the storm and reap financial gains since they have the muscle to invest in distressed assets during such turbulent times.”



The rise of sovereign wealth funds

Mohammed Dahmash, *Ernst & Young*

Mohammed is a leader of Ernst & Young's Real Estate Transaction and Advisory Services group in the Middle East. Based in Dubai, he pioneered the firm's benchmark survey report covering the Middle East's hotel industry. Mohammed has extensive experience in corporate finance, hospitality and real estate.

Innovations in the prime and subprime mortgage markets, coupled with a lax regulatory environment, had dramatically increased the risky lending practices to home buyers. This ultimately led to the tumbling of the US housing markets in 2007 and contributed to the global liquidity squeeze and shakeout of the world financial system. Consequently, central banks have rushed to inject liquidity into their economies to restore order in the markets and regain investor confidence. In the midst of this, sovereign wealth funds (SWFs) remain well-positioned to weather the storm and reap financial gains since they have the muscle to invest in distressed assets during such turbulent times.
It is important to understand SWFs, their source of funds, their benefits to global economies, and the challenges faced by SWFs in their real estate investment strategies.

So what are SWFs? Sovereign wealth funds are typically formed by governments of countries that have a budgetary surplus. Rather than hold the excess capital in cash or dilute it through unnecessary public spending, this excess capital is placed in a SWF and appropriately invested for financial gains. Currently, there are 51 SWFs with a combined asset base of approximately US$3.05 trillion. SWF assets could grow as high as US$11 trillion by 2013.

SWFs have been extensively covered by the media in recent years and criticized in many political circles. Their origin dates back to the early 1950s when Kuwait established its first fund. Today there is an obvious shift in investment patterns as emerging and developing countries have become “net creditors” for many of the major mature economies.
Much of the criticism of SWFs involves the source of the funds, the government's transparency in dealings and its ability to hold an investee country hostage economically and politically due to their sovereign ownership and financial clout. Some critics have even mentioned that investments made by SWFs in sensitive industries could compromise a country's security.

SWFs are becomingly increasingly active in global real estate. SWFs typically invest in their local, as well as in international, real estate markets through direct and indirect investments. Some SWFs also form a separate real estate arm.

Local real estate investments are aimed at improving and developing local infrastructure, while simultaneously creating jobs for the local population. International real estate investments are primarily used for attractive returns and to hedge against other investment risks.

Some challenges to the growth of SWFs in the present financial environment are their ability to identify and exploit global and “trophy” real estate investment opportunities and projects that could have synergistic benefits. An equally important consideration that will always influence the decision making process is their ability to find and select similar status local market partners. On the other hand, SWFs continue to face the risks associated with managing the legal and transparency issues in the host country; international fears that they could hold a country hostage economically and politically; lack of industry and local market knowledge; and, in many cases, the absence of a professional in-house asset management function.

In conclusion, the phenomenal growth of SWFs is likely to continue in the future. Noticing the potential benefits, more countries are considering formation of their own SWFs. As their growth continues, it is likely that SWFs could increase their exposure to real estate markets, and could be serious players in the international real estate arena — even if they maintain their current capital allocation percentage.

7 Pricing uncertainty

At seventh on the list this year, pricing uncertainty is a new entrant into the top 10. While real estate value estimation is inherently uncertain, the challenge of getting pricing right today has been intensified by the economic slowdown, which caused a decline in real estate values and a subsequent oversupply of properties.

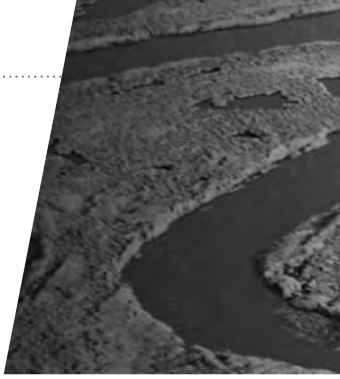
There are two key issues related to pricing uncertainty. The first concerns overvaluation of real estate portfolios and, more precisely, a discrepancy between property valuations and current transaction prices. From a European perspective, real estate funds are valued significantly below net asset value, suggesting their real estate is potentially overvalued by 10% to 20%. The decrease in trading volume has caused a lack of comparable prices. As one Ernst & Young analyst put it, "Indicators of value that were valid in the past are now becoming increasingly irrelevant." Moreover, European markets have deteriorated, but there are many countries where we still see little yield shift on the assets.

The second issue is that increased pricing uncertainty tends to make investors uncomfortable with entering into new transactions. One US-based analyst attributed the more than two-thirds decline in transaction volumes following the onset of the credit crisis not only to the lack of financing availability but also to this pricing uncertainty. Commercial real estate transactions are seen as particularly vulnerable. Companies are holding on to their assets, waiting to get the right price. "But is the market at the bottom or are we only half way through? Should they wait or act now?" asked one analyst. Not all markets will be affected or recover in the same way.

Meanwhile the inflation outlook has changed dramatically. The price of crude oil and raw materials has dropped sharply and if raw material prices remain at these lower levels, prices could turn sharply negative in 2009.

Steps companies can take to respond to this risk

- Understanding financial reporting, tax and transaction risks and ensuring they are factored in when considering transactions.
- Formulating a strategic plan that identifies current and future risk on a global basis. Plan for the risk and identify mitigation factors.
- Conducting appropriate due diligence and understand deal fundamentals.



"In addition to being socially responsible, going green is becoming more affordable and, with rising energy costs, definitely has appeal."

8 Green revolution, sustainability and climate change

The green revolution has risen one place on the risk list since the 2008 report. Today, environmental issues are firmly on the corporate agenda. We see some of the largest global corporations committing billions of dollars in response to the green agenda, as well as significant commitments to improve performance, particularly on reducing carbon emissions. One analyst expected that, "In the next construction cycle in the US, virtually all new major office buildings will be green and tenants will be better informed about the operating cost savings and employee productivity gains in green buildings." This is likely to have a negative impact on the value of existing Class A buildings that are not compliant and boost the retrofitting of existing buildings.

The green agenda lately has been bolstered by a number of factors. These include a mounting political momentum and regulation (particularly on carbon emissions), increasing energy and raw materials costs, and the potential reputational damage of appearing to be irresponsible in addressing environmental issues.

The risks from climate change are far reaching and affect every aspect of business. Companies' supply chains could be affected by the vulnerability of critical ingredients and/or materials to a changing climate and the increase in operating costs. Their production systems also may be exposed to new regulation, increasing costs and increasing demands of stakeholders for emissions reduction. In sales and marketing, organizations will be exposed to the changing preferences of increasingly environmentally conscious consumers.

The green revolution also represents opportunities for companies to position themselves strategically and gain a competitive advantage. Indeed, green buildings are likely to secure more development finance, attract new tenants seeking green spaces and/or reduced occupancy costs and have stronger investment value. One analyst argued that international real estate companies should become leaders in bringing the green revolution to developing markets.

Steps companies can take to respond to this risk

- Recognizing and adapting to increased sensitivity to, and prominence of, the environmental agenda.
- Understanding where your organization is exposed. This involves going beyond the impact of the green agenda on your value chain to understanding the expectations of stakeholders — from regulators and employees through to the customer. It entails understanding how others are responding and where their responses have been flawed; having a clear view of mitigation opportunities and the associated costs; and having leadership demonstrate the strategic commitment of the organization.
- Aligning with appropriate advisors to help move through the "greening" process.
- Having a clear understanding of tax and other incentives available to help achieve a green agenda.

The world is turning green

Katherine Hammack, *Ernst & Young*

Katherine is part of Ernst & Young's Climate Change and Sustainability Services Tax practice. She helps clients identify tax and utility incentives, which can partially offset costs associated with climate change and sustainability efforts. Katherine also helps clients to obtain LEED green building certification and identify sustainability strategies.

In addition to being socially responsible, going green is becoming more affordable and, with rising energy costs, definitely has appeal. Many real estate companies have started to go green, or are considering it, but typically they have a fragmented (instead of a strategic) approach. Companies that want to go green need to consider the following:

(1) Develop a green strategy for your real estate.

(2) Determine what you want to report on your sustainability metrics.

(3) Identify the impact of climate change regulations on your bottom line.

Green

In real estate, "green" is generally considered Leadership in Energy and Environmental Design (LEED) certified. LEED is a certification program established by the US Green Building Council. The first program developed was for new construction (LEED-NC) and focuses on the characteristics of designing, engineering and constructing a green building. Other programs were later added for existing buildings core/shell and commercial interiors. These are all being merged together in the LEED 2009 program.

LEED affects building codes in several ways. Sometimes, as an incentive, companies can receive expedited permitting, tax credits or grants for certifying a project as green. At other times it is a mandate, such as in the city of Los Angeles where all new construction over 50,000 square feet is required to be LEED certified. US states such as New Mexico, Oregon, New York, Nevada, Maryland and Virginia offer tax incentives and credits that could result in most, if not all, of the incremental cost for LEED certification being offset.

LEED certified buildings tend to retain value, sell at a faster rate and have higher tenant occupancy. Real estate companies investing in green are clearly benefiting.

Sustainability

Sustainability embraces many aspects of green, but goes one step further. It defines all aspects of a business enterprise including labor policies, human rights, social indicators, environmental activities, product responsibility and economic impacts.

Leading companies are producing sustainability reports that disclose their efforts in each of these areas to stakeholders. Concern over inconsistency in these disclosures has led to the Amsterdam Global Reporting Initiative (GRI), which pioneered the development of the world's most widely used sustainability reporting framework — the Sustainability Reporting Guidelines. GRI is committed to its continuous improvement and application worldwide.

Currently, sustainability reporting in most countries is a voluntary way for companies to tell their stakeholders about the investments they are making in their businesses and the future as well as the company's progress and successes. In the next five years, publicly held companies can expect this non-financial reporting to become a requirement.

Climate change

Whether or not you believe in global warming, the fact remains that visible emissions from the combustion of fossil fuels in energy use cannot be good for the environment. In response to this, carbon emissions cap and trade programs have been set up as a way to combat the pollution coming primarily from utilities and other large businesses.

The first cap and trade system in the US was set up in the New England states, and the first sealed bid auction of carbon credits took place in September 2008. Utilities were required to purchase carbon credits in proportion to their emission characteristics. This will increase the cost of electricity in the Northeastern US. The profits from the auction are expected to be reinvested in each state through incentive programs for renewables and energy efficiency. Some states may even expand their incentives for LEED construction. The western states have almost completed their program development, and their cap and trade program is expected to launch in the next two years. Now the federal government is considering a program that would address this as a national issue.

If you are not investing in green now, the increased cost for electricity may be your driver.

"Over the past five years, declining real estate returns in many mature markets forced funds and investors to look to new geographies to achieve desired returns."

9 Economic vulnerability and regulatory risks in developing markets

At number nine is another new risk that increasing globalization has forced real estate investors to consider. This risk builds on 2008's volatility in emerging markets risk and involves the higher economic volatility and regulatory uncertainties companies face when they extend their operations to emerging markets. Over the past five years, declining real estate returns in many mature markets forced funds and investors to look to new geographies to achieve desired returns. These moves to less mature geographies require investors to factor a greater risk of market volatility into investment decisions.

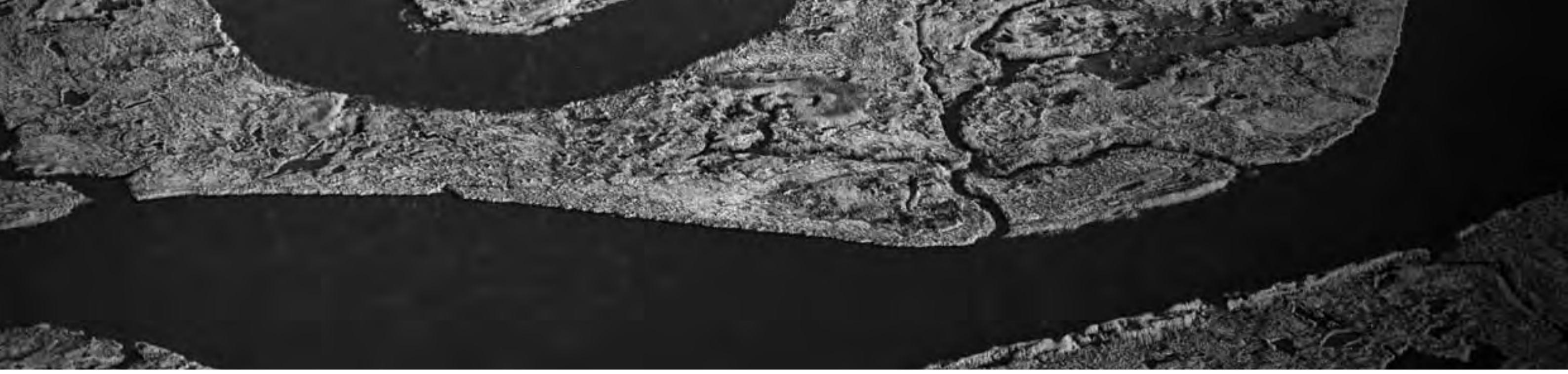
However, much of the headline volatility in the sector over the past year has occurred in wealthy, mature markets including the US and UK. It is now the uncertainty in these markets, with valuations, debt levels, and exit strategies etc. that have funds and investors sitting on the sidelines considering their investment options.

Nevertheless, at a fundamental level, it is emerging economies — with their typically higher economic volatility and political instability — that are likely to be more vulnerable to economic shocks, political unrest or interest rate fluctuations. Regions that are dependent on foreign direct investment, such as Central and Eastern Europe, may be significantly impacted by market factors around the world. Further, emerging countries may not have the resources to impact local markets the way more mature countries can.

In addition to market risks, the regulatory environments in developing and mature markets differ markedly from one another. Being able to manage specific local regulations (such as tax laws and property rights) is a crucial strategic challenge. One common issue is the process of acquiring new construction permits, which is often less mature in developing markets. Moreover, failing to understand the local tax code can expose an investor to substantial risk. One Ernst & Young analyst, based in Russia, advised international investors and Russians alike to have respect for local governments and the administrative power they represent. "As long as due regard is given to appropriate regulations, the risks in the Russian market are not any greater than the rest of Europe."

Steps companies can take to respond to this risk

- Committing long-term to emerging markets. Companies must be prepared for a learning curve to really understand the opportunities and related risks in an emerging market. Economic, political and regulatory risks are difficult to identify and define in these markets, which are rapidly changing. Organizations should be prepared to invest some time to understand the environment and be able to manage the risks intelligently.
- Building strong relationships with local regulators and authorities to help understand local market rules and regulations. Much of the vulnerability and regulatory risk is related to local (or national) authorities.
- Identifying and partnering with the right local company that understands the market, cultures, opportunities and risks.



10 Volatile energy costs

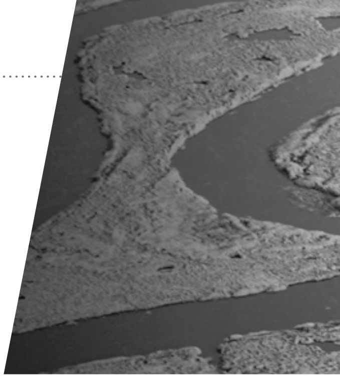
After witnessing the impact of the 2008 energy price spike, a number of analysts felt that volatile energy costs could pose a significant new strategic challenge to the industry. The spike had been driven by a number of interrelated factors including demand growth (particularly in the developing counties), a slowdown in supply growth, reduced government subsidies, energy market trading activity, and economic, political and environmental issues in key producing and consuming regions.

As energy costs fluctuate so do the costs of transportation, which, in turn, are likely to affect the location of facilities and patterns of occupancy. The largest effect of increasing energy costs on the real estate sector is likely to be the change it brings to the demand for real estate. As one analyst wrote, "We will see more green buildings, more transit-oriented development, higher densities, changes in warehousing patterns as rail and barge transportation substitutes for trucks, reductions in personal and business travel, etc." Despite the subsequent reduced cost of oil, we are still seeing significant efforts by real estate users to reduce the amount of space they occupy in order to reduce the amount of energy needed to maintain a facility and therefore reduce overall occupancy costs. Moreover, there are efforts to locate businesses in areas where energy costs are relatively low or where the energy market is less volatile. As one analyst noted, "We are already seeing some reversing of outsourcing as transportation costs exceed the economic benefit of lower labor costs. This, of course, will change real estate use patterns."

Like many risks, the challenge of volatile utility costs also presents developers, users and investors with an opportunity to re-examine current practices, and to implement response plans that could put them ahead of their competitors.

Steps companies can take to respond to this risk

- Recognizing that the risk of increasing energy costs will be a long-term risk that requires continuous response, planning and monitoring.
- Establishing comprehensive energy management plans to control and/or reduce energy costs. Some energy management tactics include negotiating energy contracts that protect the company from market fluctuations, implementing a workplace strategy that allows employees to work from home, adopting energy efficient designs for new real estate developments or retrofitting existing facilities, and seeking tax and/or economic incentives available to sustainable developments and/or operations.
- Making management of increasing energy costs a part of a company's enterprise risk management plan, so that it is considered when a company develops and reviews its business strategy. This applies to many business activities such as outsourcing, re-location, construction and implementing new human capital strategies.



What's below the radar?

1 Continued uncertainty and impact of the credit crunch

2 Global economic and market fluctuations

3 Impact of aging or inadequate infrastructure

4 Global war for talent

5 Changing demographics

6 Inability to find and exploit global and non-traditional opportunities

7 Pricing uncertainty

8 Green revolution, sustainability and climate change

9 Economic vulnerability and regulatory risks in developing markets

10 Volatile energy costs

11 Geopolitical shocks

12 Financial reputation

13 Inability to insure certain properties

14 Regulatory and compliance risks

In addition to identifying the top risks, we also asked our industry commentators to identify risks that sit directly "below the radar" and may emerge to top the risk lists in years to come.

Below the radar – the next four

11 Geopolitical shocks

Geopolitical shocks – identified as the final top 10 risk last year – can arise as a result of several factors, including terrorism, outbreak of war, change of administration and political uprising.

Given their nature, infrastructure assets are particularly vulnerable to geopolitical risks. A major terrorist event, while relatively short term, can be expensive. One analyst expressed concern about a possible outbreak of war between nations, particularly in the Middle East, which could involve "destruction of value far beyond the impact of terrorism."

Referring to Russia and its various internal and external tensions, one Ernst & Young analyst wrote, "The question for an investor is to weigh the impact of being subject to this somewhat difficult business environment against the potential profits and rewards of the longer term. A country advancing and improving steadily, however slowly, can be forgiven for some present turbulence – in order to realize the profits from a perceived more stable future."

12 Financial reputation

As competition for scarce debt capital intensifies, a robust financial reputation and good credit ratings become increasingly important to retain competitive advantage. This is why financial reputation deserves a place on the risk list this year. As one analyst noted, good governance, corporate behavior and corporate communications have always run a distant second, in the competition for scarce management attention. In more challenging times, demonstrating a well-controlled and governed business can be the difference between being able to close a deal or not.

Risks related to financial reputation can come from several sources. For example, the management of a company must be able to communicate information in a clear, accurate and balanced manner while at the same time complying with regulatory reporting frameworks. In the context of today's volatile markets, it becomes ever more important for companies to present information in a timely manner, or risk losing the trust of its stakeholders.

Another issue is so-called "systematic management bias," which can create a bias in estimated figures, as managers consciously, or unconsciously, select estimation techniques and assumptions that favor the firm's positions. All companies have to make use of financial estimation at times and although it is an accepted practice, it is inherently uncertain. It is imperative that the estimation is done within an acceptable range. Misleading financial data can be a serious concern and any real uncertainty in financial data must be made absolutely clear to the stakeholders. If a company gets any of these information-related processes wrong, they risk obtaining a bad financial reputation, at best. At worst, they risk being prosecuted for fraud.

Companies must have an oversight of their governance framework and understand their financial responsibilities. To accomplish this, an internal evaluation should be complemented with an external appraisal or audit. Companies need to evaluate their own track record and identify a leading practice process.

13 Inability to insure certain properties

The possible inability to insure certain properties — a below the radar risk last year — remains a threat to the real estate sector. The expectation that the government will step in as an insurer of last resort may not be true in the era of global warming. The floods of the Mississippi River and the earthquake in China in the last year demonstrate that we are all vulnerable to natural disasters. Cash-strapped governments may be unwilling to assume the role they have traditionally played.

It is not only weather or climatic factors that pose obstacles to property insurance. In war-torn regions and those experiencing political unrest, insurance is largely unavailable or unaffordable. Financial shocks can create multi-dimensional problems: while insurers worry about which property, and, in which region, they can offer insurance, customers worry if it is safe to get insurance from certain insurance companies.

One Ernst & Young analyst believed that insurance is not typically a major part of a real estate account, which can explain the risk's position below the radar. But as real estate insurance is becoming more complex, it is an issue companies need to address. A property without insurance may not attract lenders or investors. Moreover, damage to an uninsured property in any catastrophic event would likely result in huge financial losses.

We increasingly are seeing companies insuring properties as part of a portfolio. Often the portfolio may consist of a number of high and low risk properties, all at the same rate. By doing this, the low risk properties compensate for the high risk ones and companies are able to spread the risk.

14 Regulatory and compliance risks

The analysts surveyed did not feel that regulatory and compliance risks warranted the high place it attained in the 2008 report. Although it still remains a risk — our final below the radar threat — some analysts believed that it is a more pressing issue for financial institutions than for the real estate industry. According to Nick Brown, Assistant Director, Transaction Support for Ernst & Young, the steep drop of the risk can be explained by the current condition of the financial markets. He wrote that, "Companies moving into non-traditional geographies and asset classes face increased exposure to this threat. Given the shortage of credit, this should move down the list as fewer firms will be affected in the short term. Once credit markets re-open, this risk will again rise to near the top."

Compliance risk can be defined as the current and prospective risk to earnings or capital arising from violations of — or non-conformance with — laws, rules, regulations, prescribed practices, internal policies, and procedures, or ethical standards. It arises in situations where the laws or rules governing investment in real estate may be ambiguous or untested, and is more often the case in emerging than mature markets. Indeed, it is often the case that laws and regulations in emerging markets are poorly established, unsophisticated or simply different from those in place in mature markets. This is particularly relevant to taxation, zoning and property rights.

This risk exposes an investor to fines, civil money penalties, payment of damages, the voiding of contracts and loss of property rights. Failing to manage compliance risk can also lead to diminished reputation, limited business opportunities, reduced expansion potential, inability to enforce contracts and value losses due to insufficient zoning protection.

"Companies moving into non-traditional geographies and asset classes face increased exposure to this threat."

Contacts

Leader	Telephone	Email
Global Real Estate Center		
Howard Roth (Global & Americas Real Estate leader, New York)	+1 212 773 4910	howard.roth@ey.com
Richard Sinkuler (Global Real Estate Markets leader, Chicago)	+1 312 879 6516	richard.sinkuler@ey.com
Europe, Middle East, India and Africa		
Dean Hodcroft (Area leader, London)	+44 207 951 4870	dhodcroft@uk.ey.com
Malcolm Bairstow (Advisory Services, London)	+44 207 951 3685	mbairstow1@uk.ey.com
Hartmut Fruend (Transaction Services, Frankfurt)	+49 (6196) 996 26351	hartmut.fruend@de.ey.com
Americas		
Mark Costello (Advisory Services, New York)	+1 212 773 0142	mark.costello@ey.com
Michael Straneva (Transaction Services, Phoenix)	+1 602 322 3610	michael.straneva@ey.com
Far East		
Mark Smith (Co-Area leader, Shanghai)	+86 21 2228 3003	mark.smith@cn.ey.com
Soo Hock Teoh (Co-Area leader, Kuala Lumper)	+60 3 7495 8000	soo-hock.teoh@my.ey.com
Oceania		
Stephen Chubb (Area leader, Sydney)	+612 9248 4799	stephen.chubb@au.ey.com
Japan		
Shohei Harada (Area leader, Tokyo)	+813 3503 1283	harada-shh@shinnihon.or.jp

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 135,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit www.ey.com

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.

Oxford Analytica

Oxford Analytica is an international consulting firm drawing on over 1,000 senior faculty members at Oxford and other major universities and research institutions around the world. It acts as a unique bridge between the world of ideas and the world of enterprise.

Founded in 1975 by Dr. David R.Young, *Oxford Analytica* has built an international reputation for seasoned judgement on and analysis of geo-political, macroeconomic and social developments and their implications for industries and governments worldwide.

Further information about *Oxford Analytica* can be found at www.oxan.com

www.ey.com

EYG no. AU0241