Connections

Harbert Management Corporation

2010 Annual Report

HMC®

The Right Connections Make All the Difference. Our goal for 2010, as it is every year, was to forge powerful connections between investors and their aspirations. We do this by playing up our strengths, three key differentiators that make us unlike the vast majority of alternative asset investment firms out there: Connecting your investments with ours. We sit side by side with our investors and will continue to do so no matter what happens in the market. As significant investors in every fund we sponsor, on the same terms and conditions as our partners, we have a vested interest in generating attractive risk-adjusted returns no matter what the economy or markets are doing. The substantial amount of sponsor capital we commit to each strategy compels us to invest wisely, in a disciplined manner, valuing absolute returns every bit as much as you do. Connecting experience and opportunity. Each of our funds is managed by a battle-tested team that's been investing together through all sorts of economic cycles. These teams also have a good mix of financial as well as operational experience, which gives them a unique perspective in identifying opportunity and assessing risk. Their experience and discipline is what allows us to keep our strategies consistent and adhere to the basic concepts on which we have been managing capital for the last 15 years. Connecting investment focus with back office support seamlessly. Because we're investors, not an asset management firm simply creating vehicles to charge big management fees, we ascribe to high standards for research, reporting and transparency. We don't make an investment – whether a power plant, PE company or stock investment – without tearing that investment apart, taking it down to grass roots to see how it works. Fundamental research is the absolute standard by which we live. Backing us up is the Harbert Management Corporation back-office infrastructure that supports the various investment teams with risk management, legal and compliance, accounting, investor relations and investor reporting services. These services allow the investment professionals to focus their attention on research, diligence and investing capital, and allow each HMC-sponsored fund to operate at an institutional-quality level. These services are also available to assist portfolio companies where appropriate. Finally, we are committed to providing 100% transparency in the exchange of information with our partners regarding their investments. We strive to not just meet, but exceed industry standards. We're confident that these differentiators helped us not only survive but thrive in a challenging economy. And they serve to reassure investors that we are driven every day to measure our success in terms of theirs.

Harbert Management Corporation Funds		Final Close
REAL ESTATE		
HREP I	Harbinger Real Estate Partners I, L.P.	June 23, 1995
HREF II	Harbert Real Estate Fund II, LLC	September 30, 2002
HREF III	Harbert Real Estate Fund III, LLC	November 17, 2006
HUSREF IV	Harbert United States Real Estate Fund IV, L.P.*	In subscription
HEREF	Harbert European Real Estate Fund BV	July 31, 2003
HEREF II	Harbert European Real Estate Fund II, L.P.	March 30, 2007
HEREF III	Harbert European Real Estate Fund III, L.P.	In subscription
PRIVATE CAPITAL		
HPEF I	Harbinger Private Equity Fund I, LLC	December 15, 1999
HPEF II	Harbert Private Equity Fund II, LLC	December 23, 2004
HPEF III	Harbert Private Equity Fund III, LP	In subscription
HAV	Harbinger/Aurora Venture Funds	March 31, 2000
HVP	Harbert Venture Partners, LLC	December 31, 2004
HVP II	Harbert Venture Partners II, L.P.	October 29, 2009
HVP III	Harbert Venture Partners III, L.P.	In subscription
HMP	Harbinger Mezzanine Partners, L.P.	December 22, 2000
HMP II	Harbert Mezzanine Partners II, L.P.	January 10, 2006
HIPF I	Harbinger Independent Power Fund I, LLC	June 16, 1997
HIPF II	Harbinger Independent Power Fund II, LLC	February 15, 2002
HPF III	Harbert Power Fund III, LLC	June 29, 2007
HPF IV	Harbert Power Fund IV, LLC	In subscription
HAPE I	Harbert Australian Private Equity Fund I, L.P.*	September 21, 2010
ABSOLUTE RETURN STRATEGIES		
HCOF	Harbert Credit Opportunities Fund, L.P.*	Open-ended
HEMF	Harbert Emerging Markets Fund, L.P.*	Open-ended
HEOF	Harbert Event Opportunities Fund, L.P.*	Open-ended
HVF	Harbert Value Fund, L.P.*	Open-ended

** Offshore feeder fund or parallel fund also available*

Harbert Management Corporation

Birmingham . New York . Richmond . Nashville . Atlanta . San Francisco
London . Madrid . Paris . Melbourne

Corporate Profile

Harbert Management Corporation is an investment firm managing approximately $2.8 billion in assets and committed capital as of December 31, 2010. Our portfolio, a disciplined balance of risk and return, is comprised of 11 alternative asset classes in three areas of concentration: real estate, private capital and absolute return strategies. Our funds attract investors from around the world and from many sectors, including endowments, foundations, fund of funds, family offices, pension plans, banks, insurance companies and high-net-worth individuals. We make each commitment of capital with a disciplined focus on risk, absolute return and diversification.

We (HMC and our affiliates) make significant investments in each strategy on the same terms and conditions as our Limited Partners. This alignment of interest serves to reassure investors of our ability to source, close, develop and exit transactions profitably. Also reassuring: our institutional infrastructure that supports our diverse set of investment strategies with separate legal, accounting, compliance and risk management teams centrally located at our headquarters in Birmingham, Alabama.

In addition to our headquarters in Birmingham, we have satellite offices in New York, Richmond, Nashville, Atlanta, San Francisco, London, Madrid, Paris and Melbourne. Our offices are close to the relevant markets for their respective strategies, while our centralized risk management and compliance programs enable these teams to concentrate on their goal of delivering superior risk-adjusted returns.

All of this is accomplished with complete transparency to our investors.

REAL ESTATE:
United States
European

PRIVATE CAPITAL:
Private Equity
Venture Capital
Mezzanine Capital
Independent Power
Australian Private Equity

ABSOLUTE RETURN STRATEGIES:
Credit Opportunities
Emerging Markets
Event Opportunities
Value

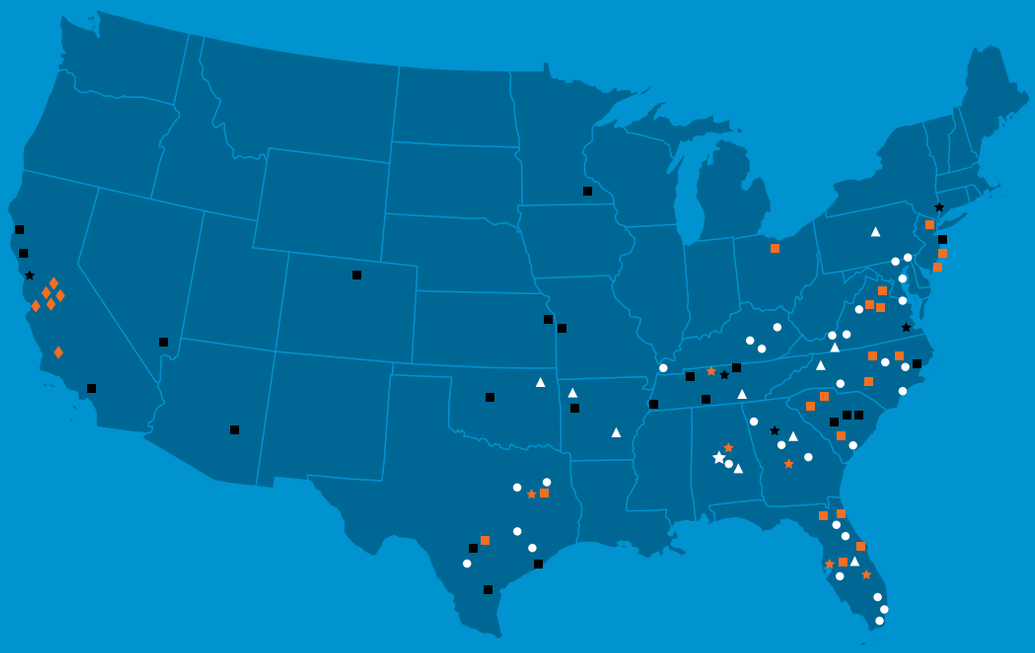
Harbert Management Corporation

Locations and private capital investments as of December 31, 2010

- ★ HMC Headquarters
- ★ HMC Investment Offices
- ★ Harbert Realty Services Offices
- ● United States Real Estate Investments
- ● European Real Estate Investments
- ▲ Independent Power Investments
- ◆ Independent Power Managed Assets
- ▲ Private Equity Investments
- ■ Venture Capital Investments
- ■ Mezzanine Capital Investments
- ■ Australian Private Equity Investments

Europe

United States



Australia

2010
The Year in Review

Raymond J. Harbert
Chairman &
Chief Executive Officer

Letter to Partners, Associates and Friends

"If I had a world of my own, everything would be nonsense. Nothing would be what it is, because everything would be what it isn't. And contrary wise, what is, it wouldn't be. And what it wouldn't be, it would. You see?"

"Alice" from Alice's Adventures in Wonderland

The wealth destruction and the extreme volatility in asset values that rolled through all asset classes and investment strategies starting in the third quarter of 2007 and into early 2010 left investors in a catatonic state as to the deployment of new money or the exposure of their capital to almost any investment risks.

This led to an "Alice in Wonderland" investment environment where many investors "hid" in cash or historically low risk, highly liquid fixed income assets. The stampede of capital into these securities has driven their prices to levels where absolute returns at the short end are tiny and any return gained by extending duration exposes capital to significant risk in the event of inflation, rising market yields or widening credit spreads. Long-term investment commitments to attractively priced private market assets or hedge fund strategies in the public market were deemed too risky. We had fallen down the proverbial "rabbit hole."

The old conservative had become the new risky; traditionally safe investments such as high-grade short-term investments, longer term bonds or anything else that generated yield, had been priced beyond perfection but had exposure to a myriad of risks – risks that were difficult to underwrite. These risks began with the sacrifice of any prospect of absolute return compounded by exposure to inflation, rising yields,

erosion of the dollar and deterioration of sovereign and state creditworthiness. It was a very frustrating time for us as an investment management firm because we felt there were many excellent opportunities to put capital to work in investments with attractive absolute returns and without exposure to these macro risks. Unfortunately, because of the fear caused by the 2008 and 2009 collapse it was extremely challenging to convince others of the propriety of investing.

Perhaps the most striking example of the conundrum we faced was in our Australian private equity strategy. We launched the fund in late 2008 with HMC partner capital and began to make investments. The economic and investment environment in Australia proved to be even better than we had expected. We made several investments in 2009 and 2010 in rapidly growing businesses at valuations substantially below levels that could have been achieved in the U.S. HMC opened the fund to third-party investors, but found very few. In the fall of this year the embedded value of the portfolio had increased to the point that the current investments had to be "ring fenced" to protect the few partners in the fund from experiencing unfair dilution. Ultimately, HMC and the fund's other investors added additional capital to the partnership and closed it to new investors.

Our ability to find attractive investments at a pace that exceeded our third party fundraising continued into the fourth quarter of 2010.

Our ability to find attractive investments at a pace that exceeded our third-party fundraising continued into the fourth quarter of 2010. Two notable examples were the acquisition of an 18-story West London office tower and the purchase of the equity interests of GWF Energy from an affiliate of a public utility. Both of these transactions represented exceedingly attractive "special situation" investments. The HMC European Real Estate team was able to renegotiate the key leases in this office building, prior to closing, resulting in an extremely attractive pro forma going in yield and expected return. The GWF Energy deal was the culmination of years of work by Harbert Power Corporation who had owned a minority interest in the assets and negotiated the recent purchase contingent upon obtaining a long-term power sales agreement and the authority to expand the facilities and convert them to combined cycle power generation.

Despite the apparent attractiveness of these and other transactions, investors have been slow to commit to new funds and investments. Consequently, a very high percentage of committed and "closed on" capital in 2010 came from HMC shareholders and affiliates.

As our aforementioned "frustration" intensified and became somewhat "institutionalized," the HMC executive committee engaged an independent consulting firm in the second quarter of 2010 to evaluate and assess HMC's business principles, practices and overall business model. We had not sought out third-party advice and input on Harbert Management Corporation since its founding 17 years ago.

After the four-month engagement, which encompassed the review of thousands of pages of qualitative and quantitative data and over 50 client, employee and investment industry interviews, we were given three broad observations about our firm.

- Our core investment management skills defined our firm and dominated our culture.
- Our operational infrastructure was best of class.
- Our communication of those qualities, both internally and externally, needed enhancement.

We were not surprised by the observation that we had built an investment centric firm in that approximately one-third of the money we run is our own, and in general, we have been pleased with the performance numbers that HMC's managers have put up.

For years we have had clients rave about our back office. We are always amused that they find it hard to believe it is on Third Avenue North and 21st Street in Birmingham, Alabama, and not in midtown Manhattan or on Berkeley Square, London.

With regards to communicating our investment management mission, performance and passion, the consulting study caused us to realize we had become myopic.

To begin the process of better communications with our clients and HMC professionals, we wrote HMC's first mission statement.

Harbert Management Corporation is an independent investment firm focused on fundamentally-based private and public market strategies. We seek investments that yield mid to high teen returns. Our mission is to provide strong and consistent returns to help our clients meet their investment objectives and preserve initial investment capital. We are opportunistic investors that invest alongside our clients on equal terms and conditions.

This statement summarizes and synthesizes many of the investment principles we have articulated in previous letters to you. Specifically HMC: (1) is an absolute return investor; (2) invests solely on an asset by asset, bottoms-up analysis, not macro-themes or momentum driven quantitative models; (3) we control risk through disciplined diversification and very selective use of debt, usually with recourse only to individual assets; and (4) our interests are always aligned with our limited partners' through the commitment of capital by HMC's shareholders.

Our mission is to provide strong and consistent returns to help our clients meet their investment objectives and preserve initial investment capital.

These principles have also driven the development of our business model. HMC focuses solely on the alternative investment landscape through both private market and hedge fund vehicles. Within that universe we invest primarily in equity or equity-like securities as these assets have the potential to achieve our yield objectives without relying on leverage to gear up low return assets. Our risk management is focused on the permanent impairment of capital rather than measures of short-term volatility. Consequently, we manage our downside exposure with asset by asset investment analysis, diversification, and lower leverage; rather than statistical models, the perceived safety of liquidity, or doing "big high quality deals" most of which have been priced to perfection.

Expect more regular conference calls, meetings, and written reports from the investment management teams updating clients on fund performance and market conditions.

Our efforts to improve HMC's communication with investors have also resulted in several organizational changes. We have asked Charlie Miller to focus exclusively on repositioning the firm from a marketing and investor relations perspective. He has become Executive Vice President and Global Head of Distribution. This will permit Charlie to focus solely on the management of our investor relations team. We have added two senior marketing professionals to that group: Rich Brereton whose primary focus will be on hedge funds working out of HMC's New York office, and Ken Freeman who will cover the U.S. West Coast and Asia Pacific investors out of our San Francisco office. Several additional research and support personnel have also been added to support the more intensive efforts.

Beyond these personnel changes we plan to significantly enhance the quality and quantity of communications with our limited partners. In addition to our annual investor conference, you should expect more regular conference calls, meetings, and written reports from the investment management teams updating clients on fund performance and market conditions. We also expect Harbert Management Corporation's investment professionals to be more involved and to make a great contribution to public discourse and general investor knowledge in their areas of investment expertise, which will make HMC more of a problem-solving, solution-based resource for our clients.

During 2010 we have also implemented important changes to our website and investor reporting. Investors are able to access an ever increasing volume of information about the funds they participate in online through the Investor Center embedded in the HMC website. During 2010 we have also changed our outside administrator to HedgeServ and are working towards the goal of providing statements that will consolidate all of an investor's investments across all HMC funds, which eventually will also be available online through our website.

We have transitioned all finance and treasury functions to David Boutwell and named him Executive Vice President and Chief Financial Officer. Sonja Keeton has become Senior Vice President and Chief Administrative Officer, and will assume responsibility for Hedge Fund Administration, Investor Reporting, Information Technology and Facilities Management. Thomas Hicks has been promoted to Vice President and Director of Risk Management and assumed additional responsibilities for internal audit. We expect all these changes in responsibilities to be uneventful as David has been integrally involved in the treasury and finance function for years, and Sonja will add these new responsibilities to her long-standing role as head of HMC's Accounting and Tax departments.

We measure and monitor our long-term returns to ensure we are delivering the superior results we and our clients demand of their investment managers.

An important practice of a firm like ours is to measure and monitor our long-term returns to ensure we are delivering the superior results we and our clients demand of their investment managers. To measure that performance, we establish and report each year the internal rate of return an investor would have earned by allocating to every investment platform HMC has created since the close of our first fund in 1995, in the same proportion and at the same time as the HMC shareholders and HMC affiliated entities. This year's number, reflecting 15 years of cumulative investment performance, was an internal rate of return of approximately 12% and realized cash on cash return of approximately 13%, both roughly equivalent to last year's performance. For reference, the S&P 500 and Barclays U.S. Aggregate Bond Indexes each had annualized returns of approximately 7.6% and 6.3% respectively during this same period.

All this data is net of all fees and includes both the performance of successful funds and those with substandard performance which we have closed. They reflect the asset allocation decisions made by HMC partners and affiliates; not the relative sizes of individual funds.

To make this information more meaningful to our investors who do not commit to multiple strategies, we have begun to break down the aggregate return data into categories, consistent with the way we manage HMC's portfolio:

	IRR
Real Estate	10.2%
Private Capital	21.0%
Absolute Return	9.6 %
Discontinued Strategies	(3.8%)

Real estate captures our domestic and European efforts; Private Capital consists of U.S. and Australian Private Equity, Venture Capital, Mezzanine, and Power; and Absolute Return is made up of our hedge fund portfolios. Discontinued strategies include funds started with HMC partner and affiliate capital which were shut down because they did not achieve our return objectives. These funds were not widely offered outside our firm, and consequently had little or no third-party capital. Returns are calculated consistent with the aggregate performance data - net of all fees, assuming capital was committed in the same proportion and at the same time as the HMC Shareholders and HMC affiliates, from the inception of our first fund in 1995 through December 31, 2010.

As this letter goes to print, I am reminded of something that consultant John Casey said to us last summer as we were discussing our frustration with the investment community. He said "you will have to be patient and wait for the investment tundra to thaw."

Thankfully for those of us with little patience, the thaw has begun and appears to be picking up momentum in the first quarter of 2011. I hope it is not because we have put two years between us and the worst of the meltdown, but that we are successfully informing our clients of the excellent investment opportunities that are present today and that Harbert Management Corporation is providing excellent risk adjusted investment solutions to take advantage of those opportunities.

As always, we are highly appreciative of the confidence you show in Harbert Management Corporation, and we look forward to serving your needs in 2011 and beyond.

Sincerely,

Raymond J. Harbert, Chairman & Chief Executive Officer

Michael D. Luce, President & Chief Operating Officer

Raymond J. Harbert
Chairman &
Chief Executive Officer

Michael D. Luce
President &
Chief Operating Officer

Real Estate

Connecting investors to a proven strategy.

United States Real Estate

There were several interesting developments in the past 12 months. First was the dramatic compression of multifamily yields. Market distress caused yields to increase; however, within a very short period of time multifamily yields declined below historic averages. Despite decreasing yields, the average price per unit remains low since the underlying cash flow fundamentals have only just begun to improve.

Second we were surprised by the lack of selling by the banks in the face of a historic wave of distressed debt maturities. Instead, regulators allowed the banks to extend the loans avoiding a mass liquidation of troubled assets. This reluctance to sell assets resulted in lack of meaningful deal flow, so that, from an acquisition perspective, there has not been as much activity as expected.

Finally, investors are navigating the challenges of moving from defense to offense. Many investors have been preoccupied with managing existing assets through the economic recession for the last 24 months, so they're just starting to look up and take advantage of opportunities created by the turmoil. This transition has been slow but accelerated notably in the later part of 2010.

Fortunately, as real estate operators, not just financial engineers, who have invested together through a number of real estate cycles, our expertise lies in buying assets with problems, such as material vacancy, significant deferred maintenance or a capital starved ownership structure. Candidly, that's a sweet spot for us. Going forward, the value creation in real estate should occur at the asset level through the improvement of operations and growth of net operating income. Consequently, our operating experience is a competitive advantage for us and our investors.

Though economic conditions remain challenged, we are seeing signs of stabilization and an initial recovery. Investors and debt providers are returning to the market and underlying property fundamentals are beginning to improve.

While we are wary of the lack of robust job growth and have some early inflationary concerns, we're optimistic that deal flow will increase and we will continue to put capital to work in good investments. Our specific real estate strategy of active value enhancement through operations should provide exceptional opportunities to put capital to work, at great risk-adjusted returns, in an asset class at a cyclical bottom that historically has been a good inflationary hedge.

As real estate operators, not just financial engineers, who have invested together through a number of real estate cycles, our expertise lies in buying assets with problems, such as material vacancy, significant deferred maintenance or a capital starved ownership structure. Candidly, that's a sweet spot for us.

Alan C. Fuller
Vice President & Senior Managing Director

Michael P. White
Vice President & Senior Managing Director

'10 in Review

In 2010, HMC continued to raise capital for HUSREF IV, the firm's fourth United States real estate Fund. Because of a difficult capital-raising environment, capital raising efforts for the Fund were extended until mid-year 2011. During the year, considerable attention was also placed on asset management, focusing on portfolio leasing, financing and capital needs. The investment team also continued to develop its deal flow network in anticipation of emerging distressed asset sales.

Other notable Events during the year included:

- Blanding Beatty promoted to Associate.
- Adding an Associate to the San Francisco office, Craig White, formerly with Regions Bank.
- HREF II sold one retail center and HREF III sold one office building.
- Acquired seven self-storage assets, one multifamily property in Phoenix, Arizona and one office building in Sunnyvale, California.

2010 United States Real Estate Portfolio/ Transactions

HREF III Portfolio

A summary of the assets in the HREF III portfolio at year-end 2010:

Office & Industrial Properties

Bank of America Plaza – 366,842-square-foot, Class A office building in Raleigh, North Carolina.

Interstate Business Park – 118,031-square-foot office/flex park in Tampa, Florida.

North Dallas Office Portfolio – 455,889-square-foot, Class B, three-building office portfolio located in Dallas, Texas.

East Pointe Business Center – 287,482-square-foot, Class B office/flex park located in Memphis, Tennessee.

Three Northborough – 157,304-square-foot Class B office building located in Houston, Texas.

Gwinnett Corporate Center – 1,181,022-square-foot shallow-bay distribution and single-story office park located in Atlanta, Georgia.

SunTrust Office Portfolio – A portfolio of 20 properties totaling 786,399-square-feet of office space, from an original acquisition of 25 properties, that were acquired in a partial sale leaseback transaction.

Ellington Trade Center – 503,140-square-foot, three-building, newly developed industrial project in Houston, Texas.

NorthPointe Trade Center – 448,550-square-foot, threebuilding, newly developed industrial project in Austin, Texas.

Multifamily Properties

Chalk Rock Canyon – 264-unit, Class A multifamily development located in Austin, Texas.

Dry Creek Ranch – 288-unit, Class A multifamily development located near Fort Worth, Texas.

BellaTerra at Deerbrook – 360-unit, multifamily workforce housing property located in Houston, Texas.

Mixed-Use Properties

Charleston Cigar Factory – A mixed-use redevelopment located in the peninsula historic district of Charleston, South Carolina that will be comprised of residential lofts, office condominiums and boutique retail shops upon completion.

Retail Properties

Shadow Anchor Retail Portfolio – A four-property portfolio of shadow-anchor retail centers totaling 59,960-square-feet across multiple locations.

Chace Lake Center – 13,400-square-foot shopping center in Hoover, Alabama with Harbert Realty Services.

HUSREF IV Portfolio

A summary of the assets in the HUSREF IV portfolio at year-end 2010:

HUSREFIV Self-Storage Holdings – A joint venture with W.P. Carey to acquire self-storage facilities throughout the United States. Five new storage facilities in Chicago were added in 2010, along with units in Bentonville, Arkansas, and Tallahassee, Florida, bringing our total ownership to 20 properties.

Santa Rosa, Phoenix, Arizona – A 112-unit multifamily community located in Phoenix, Arizona.

San Ventura Apartments, Arizona – A 272-unit multifamily community located in Phoenix, Arizona.

Viridian and Beach Club Apartments, Fort Myers, Florida – A 640-unit multifamily community located in Fort Myers, Florida.

645 Almanor, Sunnyvale, CA – A 130,000-square-foot R&D building in Sunnyvale, California.

HUSREF IV Acquisitions

San Ventura Apartments, Arizona – In February 2010, HUSREF IV acquired an 85% interest in San Ventura, a 272-unit multifamily property located in Phoenix, Arizona.

645 Almanor, California – In March 2010, HUSREF IV acquired a 90% interest in 645 Almanor. This 130,000-square-foot R&D office facility located in Sunnyvale, California was purchased at a deep discount to replacement cost and will undergo a complete interior, exterior and systems renovation resulting in a LEED certified class – a R&D office building.

W.P. Carey Self Storage Platform – In 2010, HUSREF IV made seven follow on investments increasing the size of the portfolio to twenty assets across nine states.

European Real Estate

If you look at the competitive landscape today, versus a few years ago, we believe it is much more attractive than when we were raising money for our last Fund (2005 through early 2007). During this period, there was a massive amount of capital flowing into the sector, resulting in nothing more than momentum or directional investing that had nothing to do with real estate fundamentals. There was a huge disconnect and that caused us to sit back and evaluate; the outcome was a feeling of being crippled and unable to put capital to work. Which, in hindsight, was a good thing, as that was the peak of the market. Many investors questioned why we had not pre-committed all the capital we were trying to raise. That was a hard discussion. However, we saw investments that were not based upon underlying real estate fundamentals and thus didn't make a lot of sense. If everyone is buying together, all you're doing is driving up prices. That's momentum or directional investing. We are not that. We are fundamental investors, plain and simple.

A lot of people are talking about their strategy. We're telling our story of what's been done. We are not projecting. It's been done, it's proven and we did it in the worst market in a long time.

Even after we raised capital, our own investors were questioning us about why we were not putting more capital to work. If you look at it, we invested more than 65% of HEREF II's capital in 2009-10, during a time experts call the bottom of the market. Further, what we bought were institutional quality assets at historically low prices with long-term income in place. As a result, our 2007 vintage Fund is actually on track to generate solid returns for its vintage class.

Every transaction we did in 2009 is ahead of our underwriting forecasts from an operating and cash-flow perspective. We are ahead on the leasing plan we had, and we are ahead on some other value-added initiatives that we didn't think would be coming to fruition this soon, if at all, in some cases.

A lot of people are talking about their strategy. We're telling our story of what's been done. We are not projecting. It's been done, it's proven and we did it in the worst market in a long time. Most importantly we maintained discipline when it was very easy not to. As a result, we don't have massive legacy issues in our portfolio that are crippling us due to poor judgment in 2005-2007. We continued coming to the office every day, continued to fight for transactions we thought were attractive but didn't change how we implemented our philosophy. We're not in this business as a means to an end. We're in this business because this is what we like, what we get excited about: making money from smart investment decisions, not creating scale and making money from infrastructure.

Tor V. Tveitane
Principal

Scott D. O'Donnell
Vice President & Senior Managing Director

'10 in Review

- HEREF II became fully invested with the investment at Crick, a prime UK distribution property near the M1 motorway and a rail freight terminal.
- HEREF III had both a first closing and made its first investment in the fourth quarter, purchasing a 143,410-square-foot, 18-story office building in West London.
- HEREF II sold a portfolio of five UK logistics facilities that it purchased in June 2009. Total cash proceeds were £82 million, resulting in a net property-level IRR of 61.5% and a net property-level equity multiple of 1.84x.
- Completed a lease extension with the largest tenant (Daimler) in our development in Esslingen, Germany.
- Received independent appraisal of the most significant investment in our portfolio, which we acquired during 2009 at a 16% mark-up on cost, triggering a reduction in the margin on the underlying debt.
- Through leasing and other value-add initiatives our 2009 multi-let acquisitions are performing ahead of our proforma projections.

2010 European Real Estate Portfolio/Transactions

HEREF I

Clemenceau, France – 70,955-square-foot office building with 124 parking spaces, located in the Nanterre submarket of Paris, to the West of La Défense.

Cadogan, London, UK – Landmark 65-room Grade II listed hotel, centrally located in an affluent residential and business area within the West End of London.

Iron Mountain Dublin, Ireland – 88,309-square-foot pre-let warehouse development in northwest Dublin, easily accessed from the M3 motorway.

Iron Mountain Munich, Germany – 35,166-square-foot warehouse development pre-let to a NYSE-listed company who is a world leader in its industry.

HEREF II

Crick, UK – 285,054-square-foot prime UK distribution warehouse adjacent to the M1 motorway and close to Daventry International Rail Freight Terminal.

SEGRO Portfolio (Leopard), UK – Four multi-let industrial estates comprising 2.1 million-square-feet of lettable floorspace and 150,000-square-feet of expansion rights located in the Southeast of England, within close proximity of London.

Parc Mail, France – 236,655-square-feet of Grade A space across 11 modern, institutional-quality office buildings within the larger Parc Technologique in southeast Lyon, France.

Promociona (Alpha), Spain – Joint venture with an experienced local warehouse/logistics developer to develop, lease and sell warehouse/logistics facilities primarily in the Madrid region of Spain.

Bergen, Norway – Preferred equity investment in a planned 160-unit residential development located on an island archipelago on the west coast of Norway, 20 miles south of Bergen.

Esslingen (Genesis), Germany – 405,000 square feet of industrial warehouse and office space, located eight miles from Stuttgart, Germany.

Ostfildern (Fleet), Germany – 175,000-square-foot industrial warehouse development, let to DHL, 4.5 kilometers from Stuttgart airport.

Ronda, Spain – 497 hectares of land in Andalucía, Spain, acquired to meet demand among Europeans for quality residences in well developed, low density golf course communities.

HEREF III

Chiswick Tower, UK – 143,410-square-foot, 18-story office building in West London.

Addition to HEREF II

Crick – On July 29, 2010, the Fund acquired a prime UK distribution property adjacent to the M1 motorway and close to Daventry International Rail Freight Terminal. The property is a 285,054-square-foot distribution warehouse, originally developed by Tesco and sits on 20.35 acres of land.

Disposal from HEREF II

ProLogis Portfolio – On November 4, 2010, the Fund successfully sold a portfolio of five prime UK distribution assets that it acquired in June 2009 to London & Stamford Plc. HEREF II was able to complete its business plan on the portfolio much earlier than anticipated and therefore decided to take advantage of strong current market appetite for prime UK assets which were acquired for £64.4 million in June 2009. The assets were sold for £82 million, delivering a net property level IRR (without any allocation of fund level fees, expenses or carried interest) of 61.5% and a net property level equity multiple of 1.84x.*

Addition to HEREF III

Chiswick Tower – On November 10, 2010 the Fund acquired a landmark 18 story, 143,410-square-foot multi-let office building in West London. The building is very well located, has great prominence and is adjacent to Gunnersbury tube and train station. The purchase coincided with the simultaneous re-gear of the existing lease with the major incumbent tenant, British Standards Institution. The business plan is to let the vacant space and drive the underlying rental level of the building.

** Past performance is not indicative of future results.*

Private Capital

Connecting investors to stability during volatile times.

Private Equity

Our private equity fund is a buy-and-build shop that sticks to traditional businesses in manufacturing, distribution, healthcare and specialized financial service areas. We focus on the lower middle market and we have never drifted into the higher-end markets, as some of our peers did. Also, we are absolute value buyers and use a conservative amount of leverage. During the heyday of 2004-2006, not only did we avoid following the crowd and go upstream chasing larger deals, but we also did not change our business model.

For us, it's been business as usual, just in a slow market.

Due to how we manage risk, our portfolio emerged with manageable long-term impact. Although some of our investments were greatly affected by the recession, they adjusted their operations and worked through the difficult times. We've been able to finance new transactions and haven't run to investors with large capital calls in order to support assets that had gotten in trouble, due to the fact that we didn't over-leverage them to begin with. For us, it's been business as usual, just in a slow market.

New deal-flow virtually stopped, as did the ability to exit investments. That cycle is beginning to recover, and we will begin to exit HPEF II assets in 2011. Our efforts to source deals directly continue to give us opportunities to evaluate, and we should be able to add our share of new assets into HPEF III in the coming year, because one thing we are aggressive about is investing on the backside of a recession. In December 2009, we purchased HPEF II's largest operating cash-flow platform at the lowest multiple of EBITDA in that fund. HPEF III has one platform investment in it and the purchase multiple is lower than the average of HPEF II. HPEF III should be a much shorter fund cycle than the predecessor funds, as investments are generally made when you're buying on the backside of a recession and selling back into the market as the economy recovers.

Winston H. Gillum, Jr.
Vice President & Managing Director

Donald R. Beard
Vice President & Senior Managing Director

'10 in Review

- HPEF II currently holds positions in ten separate platform companies in various industries and sectors.
- During 2010, HPEF II completed an add-on acquisition for STX Healthcare Management Services, Inc. to expand STX's markets to include Alabama.
- Several of HPEF II's existing platform companies successfully secured new debt facilities, completed debt restructurings or negotiated amendments to existing debt facilities.
- HPEF II also participated with other shareholders of Dent-A-Med, Inc. to purchase a substantial portion of Dent-A-Med's debt at a significant discount.
- The investment team continued to launch new industry initiatives and analyze deals for the new HPEF III, which had a first close with partner capital in late 2009.

2010 Private Equity Portfolio

HPEFII Portfolio as of December 31, 2010

CF Holding Company, Inc. – One of the nation's largest less-than-truckload carriers and logistics managers, serving furniture manufacturers, importers and retailers. Based in Lenoir, North Carolina.

Child Health Holdings, Inc. – Operator of the nation's largest chain of daycare and respite care facilities for children with acute medical conditions. Based in Tampa, Florida.

Dent-A-Med, Inc. – Consumer finance company that provides private-label credit cards to consumers purchasing healthcare services and healthcare-related products. Based in Springdale, Arkansas.

ECA Holding, LLC – A consumer finance company that operates payday-advance and title loan lending branches in seven states. Based in Chattanooga, Tennessee.

Onward Behavioral Health, Inc. – Operator of a residential treatment facility for adult women suffering from eating disorders. Based in Columbiana, Alabama.

PFC Acquisition Company, Inc. – A commercial finance company that provides asset-based working capital financing to small businesses. Based in Atlanta, Georgia.

Precision Alloys Corporation – Value-added specialty stainless steel processor and distributor that specializes in the production of flat-rolled stainless strips and coils. Based in Dallas, Texas.

PWI Holdings, Inc. – Underwriter and administrator of vehicle extended-service agreements. Also offers sales finance contracts to subprime credit consumers through select independent automotive dealers. Based in Orwigsburg, Pennsylvania.

STX Healthcare Management Services, Inc. – Provider of non-clinical management services to 29 pediatric dental clinics in major markets in Texas and Alabama. Based in Houston, Texas. (HPEF III is also a shareholder).

TBT Holding Company, Inc. – Manufacturer of aluminum end-dump, bottom-dump and tipper trailers; dump truck bodies; and other customized aluminum trailers. Based in Houston, Texas.

HPEFIII Portfolio as of December 31, 2010

STX Healthcare Management Services, Inc. – Provider of non-clinical management services to 29 pediatric dental clinics in major markets in Texas and Alabama. Based in Houston, Texas. (HPEF II is also a shareholder).

Venture Capital

The exit market for venture-backed companies has demonstrated steady improvement throughout 2010, as the average time to M&A exit from initial funding as of Q310 was approximately four and-a-half years, down from six-and-a-half years as of 2007. While average reported venture-backed M&A deal sizes continued to improve in 2010 ($142 million in Q310), we believe there is significant "survivor bias" in the calculation, given the overwhelming majority of deals do not report transaction value. Although the IPO markets are showing signs of improvement, the level of venture backed IPO activity is still significantly below historical norms for the industry. After bottoming in 2008 with only six venture-backed IPOs, IPO activity has picked up the pace with 72 venture-backed IPOs completed in 2010, still below the pace needed to support healthy exit markets.

After bottoming in 2008 with only six venture-backed IPOs, IPO activity has picked up the pace with 72 venture-backed IPOs completed in 2010. While performance and liquidity in the venture market is beginning to improve, the landscape of general partners is shifting dramatically.

While performance and liquidity in the venture market is beginning to improve, the landscape of general partners is shifting dramatically. The long-anticipated shake-out of venture managers from the Internet bubble period is well underway as bubble funds reach their contractual term limit. Fundraising by U.S. venture capital funds remains muted and is currently characterized by fewer firms raising smaller funds. The average U.S. venture fund raised $73.4 million, year to date through Q310, down 42% from the average fund size of $127 million between 2005 and 2009. As a result, many of the surviving venture funds are being forced to revise their investment strategies to reflect today's reality of longer time to exit and lower average exit evaluations.

The HVP investment team is very well positioned to continue to outperform in this challenging but improving environment, having assembled our team in 2002 during another difficult decade for the venture capital asset class. HVP seeks to identify and invest in emerging portfolio companies with high growth potential at valuations which reflect a realistic view of exit opportunities. We seek to mitigate early technology risk in evaluating investment candidates and prefer to underwrite business execution risk. We are active participants in our entrepreneurial communities and seek to identify promising portfolio company prospects and build relationships with entrepreneurs outside of the traditionally compressed fundraising cycle. We seek to maintain sector and stage diversification within our funds to balance risk and improve returns. We characterize our strategy as early growth stage investing.

Wayne L. Hunter
Vice President & Managing Partner

William W. Brooke
Executive Vice President & Managing Partner

'10 in Review

- Intelliject, Inc. achieved a second performance milestone, triggering another cash payment from our partner and bringing milestone total to $40 million since signing the agreement in November 2009.
- In December 2009, NovaMin Technology, Inc. was sold to GlaxoSmithKline in an all-cash transaction, yielding an approximate 9.6x return to HVP II. Transaction was named the "Deal of the Year" by BIO Florida at its 2010 annual meeting.
- During 2010, HVP II also made two new investments: an investment in "PeopleMatter" with a Series A investment in PMW Technologies, Inc.; also led a Series B round for ControlScan, Inc.
- HVP also made follow-on investments from both HVP II and HVP Annex to support growth initiatives at existing portfolio companies BroadSource, Inc. Clarabridge, Inc., Innovative Biosensors, Inc., JackBe Corporation, nContact Surgical, Inc., Privaris, Inc., TapRoot Systems Inc., United Software Corporation, Windchannel Communications, Inc. and Yap, Inc.

Active HVP I & II Portfolio Companies

Portfolio as of December 31, 2010

Aldagen, Inc. – Develops clinical-stage therapies related to the transplant of adult human stem cells used for tissue regeneration, treating blood diseases, cancer and genetic diseases. Based in Durham, North Carolina.

Clarabridge, Inc. – Provides Fortune 1000 businesses with customer experience analytics software as a service enabling them to develop stronger relationships with their end customers. Based in Reston, Virginia.

ControlScan, Inc. – Provides Payment Card Industry ("PCI") compliance and security solutions designed specifically for small- and medium-sized merchants. Acquirers and other merchant service providers rely on ControlScan to manage PCI compliance programs for their merchant portfolios to ensure maximum compliance rates. Based in Atlanta, Georgia.

IMBS Holdings, Inc. (formerly BroadSource, Inc.) – Offers enterprise software solutions targeted at telecommunications cost management enabling businesses to automate service order processing, track assets and inventory, consolidate and reconcile invoices, and manage information flow from network planning and engineering to operations. Based in Atlanta, Georgia.

Innovative Biosensors, Inc. – Involved in commercializing novel technology for the rapid detection of pathogens for military and homeland defense markets, food-safety testing and human diagnostics. Based in College Park, Maryland.

Intellijject, Inc. – Creates medical device drug delivery technologies utilizing its proprietary, state-of-the-art technology platforms. The company's first product, EpiCard, is an innovative auto-injector device designed to deliver epinephrine during allergic emergencies known as anaphylaxis. Based in Richmond, Virginia.

Ion Healthcare, Inc. – Offers sleep apnea management solutions to hospitals, large physician practice groups and sleep labs through the application of screening tools, diagnostic testing, treatment solutions and long-term compliance management. Based in Richmond, Virginia.

JackBe Corporation – Provides enterprise software that enables corporations to improve the functionality and performance of Web applications, delivering data from any application to any user, while meeting enterprise-grade security and governance requirements. Based in Chevy Chase, Maryland.

MaxCyte, Inc. – Offers both proprietary and partnered therapeutics, taking advantage of advanced capabilities for development and manufacturing of cell-based therapies through its proprietary ex-vivo cell-loading platform technology. Based in Rockville, Maryland.

nContact Surgical, Inc. – Developing a minimally invasive surgical platform for treating atrial fibrillation using a closed-chest procedure. Existing devices approved for tissue ablation in the United States, and for atrial fibrillation in Europe. Based in Morrisville, North Carolina.

Optimal IMX, Inc. – Provides radiology and teleradiology services to hospitals and clinics, utilizing staff and independent radiologists for reading and diagnosis in order to optimize and improve the quality of radiology services for patient care. Based in Birmingham, Alabama.

PeopleMatter (PMW Technologies, Inc.) – Offers strategic human resources and workforce productivity software that enables organizations to manage employees from initial on-boarding through full career development. Based in Charleston, South Carolina.

Privaris, Inc. – Develops wireless biometric authentication devices using fingerprint recognition technology that can overlay onto existing security systems. Based in Charlottesville, Virginia.

TapRoot Systems Inc. – Provides software and services for mobile phone manufacturers and wireless operators worldwide. Based in Research Triangle Park, North Carolina.

Unitrends Software Corporation – Offers business system continuity solutions to small- and medium-sized businesses, enabling them to get back on track when their systems or servers fail. Provides disk-to-disk, highspeed data backup and recovery capabilities in a cost-effective appliance-based solution. Based in Columbia, South Carolina.

WindChannel Communications, Inc. – Supplies wireless broadband services, offering public safety communications infrastructure and wireless Internet connectivity to municipalities and targeted multifamily communities. Based in Atlanta, Georgia.

Yap, Inc. – Creates and markets voice-enabled software which converts speech to text for voicemail applications and applications on mobile devices. Based in Charlotte, North Carolina.

Exited HVP I & II Portfolio Companies

Agility Healthcare Solutions – Provides business process optimization solutions for hospitals and other acute care facilities, using its domain expertise, proprietary software platform, RFID and other location awareness technologies to improve resource use and patient throughput. Based in Richmond, Virginia. Sold to GE Healthcare in September 2008.

NovaMin Technology, Inc. – Created a proprietary oral healthcare active-ingredient that addresses unmet oral care needs by amplifying the mouth's natural defense and repair mechanisms. Based in Alachua, Florida. Sold to a public company in December 2009.

Mezzanine Capital

We've seen steady improvement in 2010 within the financial markets. We saw the senior credit markets improve for large businesses at the beginning of the year, and this began trickling down to smaller businesses during the second half of the year. In direct correlation to this, the merger and acquisition market came back to life this year as well. These market improvements have an impact on our funds in two primary ways: we've seen both the number of potential exits of current portfolio companies and the number of financing opportunities increase significantly during 2010, especially in the second half.

We've seen both the number of potential exits of current portfolio companies and the number of financing opportunities increase significantly during 2010, especially in the second half.

We have exited five portfolio companies this year and we have an additional three companies in various stages of negotiations with prospective buyers, which we anticipate exiting during the first half of 2011. From a new deal perspective, we funded two new investments during the first three quarters of 2010 and four new investments during the fourth quarter.

Throughout the economic downturn, we were more flexible in where we played in the capital structure – moving up to take the senior role normally played by banks or moving down to play the equity role – without altering our underwriting guidelines. While this resulted in fewer deals being funded, we feel confident that the deals we financed will be successful investments for HMP II. A database of mezzanine loans maintained by one of our institutional investors going back to 1990 indicates that historically transactions done during or right after a recession typically have higher returns. We are hopeful this will be the case with our recent, pending and future transactions, as we are approaching deals with caution, skepticism and conservative capital structures.

Robert A. Bourquin
Managing Director

John S. Scott
Managing Director

Brent G. Ray
Managing Director

John C. Harrison
Vice President &
Senior Managing Director

'10 in Review

- In 2010, HMP I and HMP II closed six new transactions and made seven add-on investments for a total of slightly more than $39 million.
- The team exited five portfolio companies either through a sale of the business or a refinancing transaction. In all cases, the loans were repaid and warrants were sold.
- Four other companies repaid all or a majority of our loans while the equity components remain outstanding.
- The Funds ended the year with $232 million in combined investments.

2010 Mezzanine Transactions

New Investments

Enzymedica, Inc. – Provider of enzyme products. Based in Port Charlotte, Florida.

HMA, Inc. – Provider of third-party administration, claims management, disease management and provider network services. Based in Phoenix, Arizona.

Intermountain Drilling Supply Corp. – Distributor and manufacturer of industrial drilling supplies. Based in Salt Lake City, Utah.

IVIZE Services, Inc. – Outsource provider of litigation support services. Based in Charlotte, North Carolina.

LEJ Financial Services, LLC – Provider of vehicle title loans. Based in Chattanooga, Tennessee.

QSI Holding Company, LLC – Provider of electronic document management software. Based in Mansfield, Massachusetts.

Independent Power

Why do we feel that power assets deliver such good risk-adjusted returns for our investors, especially in today's environment? For an answer, consider Harbert Power Fund IV's initial $65 million investment. This deal is in some respects the culmination of 20 years of power industry experience in California. We are expanding a plant that recently signed a new 10-year contract with Pacific Gas & Electric, a plant we first built back in the early 2000s.

The deal, which closed in September 2010, is an excellent example of our investment strategy. Firstly, we are leveraging our hands-on experience in the power industry – experience that gives us invaluable history, as well as a skill set for developing new projects and recognizing quality investment opportunities. Secondly, we are investing in assets that have contracts to sell their output; this provides our investors a stable platform which has less risk but can still produce attractive returns. And finally, we are investing with the goals of our investors firmly in mind. These investors appreciate not only the potential for solid long-term returns with low volatility, they also appreciate that we offer multiple investment options – equity or debt interests, or a combination of the two. And we don't charge commitment fees; we only charge fees on invested capital.

At the close of 2010, we are optimistic about providing good returns for investors in HPF IV and our other Funds, and we are working hard to find additional well-structured investment opportunities similar to the California project described here. By 2012, the expansion in California is scheduled to be complete and the plant will begin producing electricity and income for years to come. The combination of our investment team's skills, network and experience provides access to projects that make these results possible.

We are investing in assets that have contracts to sell their output; this provides our investors a stable platform which has less risk but can still produce attractive returns.

Wayne B. Nelson III
President & Chief Executive Officer

Patrick E. Molony
Executive Vice President &
Chief Operating Officer

'10 in Review

- HPF III : Completed development of the HPF III portfolio – which included the equity investment in New York City's Astoria Energy and Astoria Energy II projects, and closed the project financing and equity investment for York Energy Center in the Toronto area.
- All HPF III power generation plant investments other than Dixie Pellets are projected to meet initial investment objectives.
- HPF IV: HMC's fourth power Fund held its initial close in September, then acquired an approximate 50% interest in GWF Energy. The balance of GWF Energy is owned by HIPF II and HPF III.
- GWF Energy received all necessary permits and regulatory approvals, completed project financing, and began construction of the expansion of GWF Energy's Tracy Peaker Plant that will add boilers and a steam turbine to convert to a combined cycle facility. The expanded Tracy facility, once construction is completed in 2012, will operate under a new, 10-year power sales agreement with Pacific Gas & Electric.

Harbert Power Investments

Portfolio as of December 31, 2010

Investments

Astoria Energy and Astoria Energy II (approximately 15% ownership)
Two 550 MW gas-fired plants (AE II is under construction)
New York, New York

GWF Energy (100% ownership through HIPF II, HPF III and HPF IV)

Phase 1: 94 MW gas-fired plant
Hanford, California

Phase 2: 96 MW gas-fired plant
Henrietta, California

Phase 3: 170 MW gas-fired plant (currently being expanded to 335 MW)
Tracy, California

Kalaeloa (50% ownership)
209 MW oil-fired plant
Oahu, Hawaii

Lockport (24% ownership)
200 MW gas-fired plant
Lockport, New York

Longview Power (investment in debt securities)
695 MW supercritical coal-fired plant
Maidsville, West Virginia (under construction)

Sidney A. Murray (9.93% ownership)
192 MW hydroelectric plant
Vidalia, Louisiana

York Energy Centre (50% ownership)
400 MW gas-fired plant
King Township, Ontario (in construction)

Managed Assets

Bridgewater (40% ownership)
17 MW wood-fired plant
Bridgewater, New Hampshire

GWF Power Systems (50% ownership)

Site I-Site II, Site V: 18 MW petroleum coke plants
Pittsburg, California

Site III-Site IV: 18.5 MW petroleum coke plants
Antioch, California

Hanford (50% ownership)
23 MW petroleum coke plant
Hanford, California

Australian Private Equity

The strong Australian economy is currently an attractive place to invest capital. An unparalleled economic record, world-class industry capabilities, buoyant labor market, immense natural resources and the geographic advantage of access to the fast growing Asian region means that Australia has become a very attractive foreign investment destination.

Within this economy, HAPE I is one of the few private equity funds that operates in the lower-middle market. We define this market as small to medium sized businesses with an enterprise value between $10 million to $100 million. As a team, we have extensive experience with the requirements and intricacies for investing in this space, helping management navigate rapid growth, understanding the challenges of fast changing industries or managing the intricacies of succession planning.

A lack of competition from other private equity funds in this space provides the opportunity to invest in the very best businesses and prospects. The largest challenge we typically face is orchestrating agreements amongst the relative participants, whether it's banks providing leverage or founders agreeing to sell. No one is moving as fast as they did prior to 2008 and the global financial crisis.

Over the last half of 2010, and especially the last quarter, we have seen an increase in the quality and quantity of investment opportunities. We made our third investment at the end of 2010 and expect to make a fourth in the first half of 2011. This will take our portfolio to four investments and likely see us fully invested in HAPE I.

We are committed to providing our investors with above average industry returns by capitalizing on our strengths, maintaining focus on our niche, and taking full advantage of the dynamic Australian economy.

A lack of competition from other private equity funds in this space provides the opportunity to invest in the very best businesses and prospects.

Jeremy E. Steele
Vice President & Senior Managing Director

Brendan J. Anderson
Vice President & Senior Managing Director

'10 in Review

HAPE I invested in two platform entities in 2009, both of which continue to outperform their investment cases. HAPE I completed a third investment in December 2010, acquiring an initial 60% ownership in Sumo Visual Group. During 2010, HAPE I completed two follow-on investments in Solar Shop Australia and completed a capital restructure that increased our ownership stake to 50.2%. Solar Shop Australia enjoyed a significant mark-up in fair value in the third quarter of 2010. The team continues to review numerous opportunities and our reputation and network continue to build successfully.

The Fund had its third and final close in 2010, raising additional investment capital. The investment team expects to launch fundraising for HAPE II by mid-2011.

Australian Private Equity Transactions & Holdings

Emeis Holdings Pty Ltd – Owner of Aēsop, a body, skin and hair care beauty products company established in 1987 and based in Melbourne, Victoria. Aēsop products are available in more than 27 countries throughout Australia, Asia, Europe and the U.S.

Solar Shop Australia Pty Ltd – One of Australia's leading renewable energy solutions providers that designs and installs photovoltaic grid-connected solar power systems. Based in Adelaide, South Australia.

Sumo Group Holdings Pty Ltd – A leading player in the Merchandising Signage Solutions market. The business designs and produces large format digital offset and screen printing. It also builds custom display units and large external signs (LCD/LED) and has a growing digital business which delivers customized, real-time content via its proprietary software. Based in Melbourne, Victoria.

Absolute Return Strategies

Connecting investors to calculated risk.

Credit Opportunities

To take advantage of opportunities in the leveraged credit market, we launched the Harbert Credit Opportunities Fund during the first quarter of 2011 in order to focus on an overlooked part of the distressed debt universe – the middle market. While distressed debt as an asset class has performed well over the 2009-2010 timeframe, and the majority of the distressed universe has been well covered by other managers, we feel the middle market continues to provide significant opportunities for both long and short investments. This strategy is also a natural extension of our deep understanding of and exposure to middle market investments through real estate, private capital, and absolute return funds.

Middle market credit has historically generated superior returns along with a low correlation to the rest of the distressed debt universe, and presents a compelling investment opportunity.

While market for middle market credit demonstrates current investment opportunities, our view is that these opportunities are the result of a structural inefficiency that is caused by several factors. Whether this inefficiency is driven by liquidity, a fund's mandate, or a lack of resources and expertise at the management level, the end result is an informational advantage. In turn, middle market credit has historically generated superior returns along with a low correlation to the rest of the distressed debt universe, and presents a compelling investment opportunity.

Looking forward, there are approximately $750 billion of leveraged loans and high yield bonds scheduled to mature thru 2015. While our view is that many companies with pending maturities will be able to refinance, we also believe that a significant number of companies face operating challenges, and therefore will not be able to refinance. In turn, we expect both the distress ratio and default rate to increase thereby providing a substantial increase in investment opportunities.

The Fund may invest in all layers of a capital structure, and will be focused primarily on long and short investments in the debt obligations of companies undergoing operational and/or financial stress. Long investments will principally consist of a portfolio of stressed and distressed debt, including bank debt, securities (principally publicly traded high yield debt), and private placements. Additionally, the Fund may invest in the debt of companies reorganizing in bankruptcy and may also receive equity or equity related securities of an issuer, primarily in exchange for debt instruments, as part of a restructuring transaction. Short investments will consist primarily of junior capital, including high yield bonds and public equities.

We are very excited about this middle market niche, and we look forward to meeting and discussing our strategy with you during 2011.

Gregory A. Jordan
Vice President & Senior Managing Director

'11 Introduction

Since 1997, Greg has been investing exclusively in middle market leveraged credit, and he brings significant experience as a portfolio manager, analyst, and trader. During this period, Greg has spent the majority of his time focused on distressed debt, and he has helped restructure sixteen companies and four investment funds. He also brings deep relationships with the buy-side, sell-side, and advisor community which have proven to be beneficial as he sources, analyzes, and executes distressed debt ideas.

Emerging Markets

The hedge fund space has been quite competitive, especially among smaller funds. There is competition between developed markets-centric banks trying to provide easing and stimulus to the economy, which may produce distortions that cause the economy to slow itself. The debt crisis in Greece inspired sell-off, which dramatically reduced the liquidity of the market, both for what historically would be considered liquid instruments and for investments that would be considered second-tier or third-tier liquidity. Also, the U.S., Europe and Japan suffered a great deal in the sell-off, and the level of activity has been suppressed. As a result, Emerging Markets are now going to have to compete for that capital, especially as investors see a lot of opportunity in the developed markets. So it may be more of a situation of where EM doesn't necessarily outperform on an index basis, but it may outperform on an individual name basis.

In this post-2008 period, the market is slower, less liquid, and it responds to news in a much more deliberate fashion than it has before.

Many investors have a large part of their portfolios in very low risk, or no risk investments, designed to be capital preservation-type products. If they make an allocation in something that may be directional and risk-based, we must make sure we're making good valuation-based arguments, that the technicals are supportive of the trajectories that we're hoping the stock price are going to take, and that there's a good story behind them. Hopefully doing all of these will help us to deliver solid returns, whether the market is providing support or not.

In this post-2008 period, the market is slower, less liquid, and it responds to news in a much more deliberate fashion than it has before. That has something to do with fewer participants so obviously there is less response. And the elimination of prop desk trading and risk books at the banks means that all the capital that would've been committed to the market as risk capital just doesn't exist. So you've not only reduced the number of participants on the buy side, you've also reduced the number of participants on the sell side, making it a much more difficult market where you have to decide what to do and stick with it. Historically, when the market had more of a trading dynamic, pre-2008, that was not as much of a concern. Now it can be quite slow and it can take time for stories to develop. We are a lot more patient since May and June about responding to market conditions.

At the same time, a stalemate in the market has been causing us to range trade since the first quarter of this year. So rather than basing valuations on very long-term projections in terminal values, now we're looking at three-month to two-year horizons, making our portfolio a bit more dynamic and responsive to whatever the current conditions are.

Robin Y. Yang
Director of Investments

Heather N. Leonard
Vice President & Senior Managing Director

'10 in Review

Emerging Markets performed adequately through the disruptions of the previous years and appear to have benefited from continued strong sovereign credit indicators, healthy corporate balance sheets and under-levered consumers. A proliferation of merger and acquisition activity served to satisfy cash-rich companies with idle balance sheet capacity. Emerging Markets countries joined in the currency competitiveness conflict with new capital controls and tax schemes meant to reduce demand for local currencies. Market reactions were visibly more complex than in 2009, which reflected on investment decision-making processes globally. For 2011, Emerging Markets should continue to benefit from their previous decade of austerity, may struggle with inflationary pressure and should benefit generally from a need to create efficiencies prompted by tighter conditions – if ever so slightly.

Event Opportunities

Over the course of 2010, we maintained that the stage had been set for an increase in mergers and acquisitions activity as a result of the following trends: strong corporate balance sheets with historically high cash reserves, accommodative debt markets, a large spread between lending rates and earnings yields, and for many companies, a need to augment tepid top-line growth. In fact, this process began to unfold in 2010, with the acceleration in global transaction activity. Given the healthy M&A outlook, and combined with an always-active event landscape, HEOF is well positioned to generate superior returns as the cycle unfolds.

We chose to close our trade in convertible preferreds. We had opportunistically entered this trade after the credit crisis dislocated the convertibles market and created an extremely favorable asymmetrical risk/reward proposition for converts. As the market corrected, we took profits and exited the trade and are now solely focused on our merger arbitrage and event strategies, where we see far more compelling opportunity.

Our performance has been consistent throughout an extremely volatile investment environment. HEOF's battle-tested team, together for nearly the entirety of the Fund's existence, includes four investment professionals, each of whom has between 10 and 30 years of experience on Wall Street. Since inception in 2006, we've generated positive performance in every calendar year – even in 2008 when many competitors suffered massive losses – and our cumulative returns since inception have outperformed the relevant hedge-fund benchmarks and market indices for the same period by wide margins. These returns have been driven by thorough research, extensive experience, creative thinking and a complete understanding of risk and risk management – an investment framework that we feel will continue to set us apart in the years to come.

We've generated positive performance in every calendar year – even in 2008 when many competitors suffered massive losses – and our cumulative returns since inception have outperformed the relevant hedge-fund benchmarks and market indices for the same period by wide margins.

John H. Frank
Director of Investments

Neil B. Kennedy
Vice President &
Senior Managing Director

Michael P. Reinking
Trader

Niraj Gupta
Director of Investments

'10 in Review

After a period of financial contagion, equity and credit markets once again began to focus on corporate and economic fundamentals. The result: a strong revival of the event-driven and merger arbitrage environment.

Corporate cash and the return of CEO confidence heralded an increase in M&A activity, particularly in the willingness of companies to pursue hostile megamergers. M&A was not limited to North America, as we saw buyers from across the globe vie for prized properties in multiple sectors, including health care, basic materials and technology.

Total global deal volume increased 25% from 2009 to over $2.7 trillion in 2010. Importantly for our strategy, there was a nearly 50% increase in deals larger than $500 million. The accommodative lending environment was a boon to private equity sponsors who are still sitting on approximately $500 billion of dry powder.

We are confident that our investment process, research-oriented approach, creative thinking and thorough understanding of risk and risk management will continue to differentiate us in 2011 and beyond.

Value

Our disciplined, straightforward strategy and ability to retain our composure in the face of adversity define us as a fund, and are sources of added value to our investors.

Macro trends are increasingly driving investment decisions and asset price movements across a number of markets. After a decade of poor performance, many investors have shunned equities in favor of fixed-income securities, even in the context of historically unattractive interest rates. These factors have contributed to a lack of focus on individual security selection, which can create interesting opportunities for investors with a disciplined value focus.

Within this environment, we've been able to continue to achieve attractive returns by investing in individual companies that really make a difference for us. Furthermore, we are investing both long and short with the expectation that our short investments will add to our returns while adding protection in turbulent markets. We avoid excess leverage and structure our portfolio with the objective of letting the individual positions drive our returns while limiting the potential for large, permanent losses. So while there is a lot of uncertainty in the market as a whole, there are always individual companies that are offering up opportunities one way or another – if you have the discipline to find them.

While there is a lot of uncertainty in the market as a whole, there are always individual companies that are offering up opportunities one way or another – if you have the discipline to find them.

Zachary P. Turnage
Director of Investments

A. Daniel Thomasson
Director of Investments

Todd D. Nunnelley
Vice President & Senior Managing Director

'10 in Review

We continued to identify compelling opportunities in the public equity markets on both the long and short sides in 2010. Our disciplined focus on absolute value yielded solid results, comprised of a diverse set of material individual contributors. In aggregate for the full year, the long portfolio accounted for the gains but the Fund had several notable individual contributors within the short portfolio. The results were achieved with below average gross exposure and with smaller than average positions. We continue to see compelling opportunities within our portfolio, which we believe offers strong future return potential on both sides. Further, we continue to have excess cash available to deploy and are focused on identifying attractive new opportunities. Clayton Williams joined our team late in the year as a Senior Analyst, further bolstering our analytical efforts.

Support

Connecting experience and knowledge to development.

Investor Services and Risk Management

Private Market Strategies – Our investor reporting department, in conjunction with the private funds' newly appointed administrator, manages the detail accounting of each investor's capital account, including capital calls and distributions. Reports provided include quarterly and annual investment reports as well as independently calculated fund-level performance of all private market funds. HMC's internal audit department annually reviews performance returns reported in the audited financial statements, while our external tax advisors review investors' annual tax information as prepared by the tax department.

Absolute Return Strategies – HMC's hedge fund administration department provides administrative and operational support functions for HMC's absolute return strategies. The group's responsibilities include monitoring trade capture and settlement, preparing daily performance and risk reports for management and acting as liaison to each hedge fund's respective prime brokers, custodians and administrators. They also coordinate investor servicing functions with the funds' administrators.

Internal Audit – The internal audit team ensures that we comply with investment policies and procedures adopted by HMC in various areas. This team also monitors and assists the due diligence efforts of the company's private market funds' transactions. The team's responsibilities include an annual review of performance returns, custody of assets, the conduct of periodic compliance audits and site visits to portfolio assets.

Risk Management – The independent risk management team monitors the daily trading for HMC's absolute return strategies through the use of concentration, leverage and other portfolio guidelines specific to each fund. The team also reviews the fair value determination for private investments in both private market and absolute return strategies.

Investment Committees – A separate investment committee monitors each of HMC's private market strategies. Each investment committee includes principals of the respective investment team and at least one member of HMC's Board of Directors who is not engaged in the day-to-day execution of the respective strategy. These investment committees must unanimously approve each commitment of capital and asset dispositions.

Asset Safety – Key to safeguarding our assets is the support of third party professionals. Custody of client funds and securities are held by independent unaffiliated custodians. Additionally, funds are annually audited by Big 4 international auditing firms which verify the existence of all of our funds' assets directly with the independent custodians. As both managers and investors in our own funds, we have a strong vested interest in ensuring transparency into, and safekeeping of, fund assets.

Regulatory Oversight – The following HMC subsidiaries are registered with regulatory authorities: Harbert Fund Advisors, Inc. is an investment adviser registered with the SEC. HMC Investments, Inc. serves as a placement agent and is a registered broker-dealer and member of FINRA/SIPC. Harbert European Fund Advisors, Ltd. is authorized by the U.K. Financial Services Authority to carry on certain regulated activities, and Harbert Fund Advisors (Australia) Pty Ltd holds the Australian Financial Services license.

Darlene A. Hartmann
Director of Investor Reporting

Thomas M. Hicks
Vice President &
Director of Risk Management

Sonja J. Keeton
Senior Vice President &
Chief Administrative Officer

David A. Boutwell
Executive Vice President &
Chief Financial Officer

Elizabeth A. Deuel
Director of Internal Audit

Susan M. Shalhoop
Director of Hedge Fund
Administration

'10 in Review

Our back office infrastructure is a key differentiator for HMC. It not only supports the various investment teams with risk management, legal and compliance, investor relations and investor reporting services, but it allows us to offer these services to assist portfolio companies where appropriate.

Experience and commitment are key to the success of our back office team of professionals. Our dedicated team of professionals brings more than 300 years of combined knowledge and experience in maintaining our guiding principles of integrity, accuracy and timeliness. While it's exciting to see the potential impact of new technology and systems in executing our business role, experienced knowledge of accounting, tax and investor reporting should never be discounted. This experience helps us identify significant advantages we can offer our clients. For example, in the last quarter of 2010, we transitioned our investor reporting administrative duties to a highly reputable and award-winning platform that will allow consistent and consolidated reporting over all asset classes. We believe timely data is crucial when making informed decisions our investors for which our investors rely on us.

New to the team in 2011 is Jeffrey B. Liles, Chief Information Officer.

Legal and Compliance

Our commitment to supporting our investment funds is evident in the twelve professionals and support staff, including seven attorneys, who make up our Legal & Compliance Department. The legal staff, which leads the structuring and formation of all new public and private market funds, has a deep institutional understanding of both the laws and regulations that affect our funds as well as our agreements with our investors that establish their purposes and limitations. Equally as important, the legal and compliance departments enjoy a very open and free-flowing discourse with the investment teams for all of HMC's sponsored funds – a continuous and dynamic discourse that is collegial, but also candid and professional, providing a critical foundation for strong and trusting "in house" attorney-client relationships that allow us to counsel the investment teams in their pursuit of investment returns carefully and confidently. In other words, we have worked along side the funds' investment teams for many years, we know what they do and how they do it, and we know how to support them in their efforts.

HMC's private market funds typically invest in controlling interests in privately owned businesses and assets through the purchase of illiquid equity and debt securities. Our legal staff has deep experience with the legal issues unique to private market investing, including private placements of securities, tax structuring, indemnification remedies, corporate governance and equity holder rights, and we use that experience and the judgment that comes with it to advise the investment teams with respect to their investments. Where appropriate, the funds will use outside counsel – particularly with respect to portfolio acquisitions and divestitures - and in those instances the legal department can facilitate those relationships and coordinate and streamline the outside workload.

HMC's public market funds trade equity and debt securities in multiple markets, with a variety market participants, including prime brokers, executing brokers, and their international counterparts. HMC's legal staff has significant experience establishing and administrating these trading relationships, as well as identifying and complying with regulations that concern the trading and beneficial ownership of publicly traded securities. As with the private market funds, our legal staff coordinates and interfaces with outside counsel where appropriate to ensure all applicable regulations, both domestic and foreign, are considered in connection with our public market funds' activities.

In addition to the six attorneys and three support staff comprising the legal department, HMC also has a dedicated compliance department comprised of a Chief Compliance Officer supported by two additional support personnel, one of whom is a licensed attorney. This dedicated compliance group has implemented and monitored policies and procedures designed to ensure that HMC, its subsidiaries and employees, and the funds sponsored by HMC comply with applicable securities regulations, as well as HMC's internal policies and controls. Our compliance programs include regular internal audits, licensing and training of employees and investment professionals, monitoring of employee and fund trading, and identification and management of risk and conflicts of interest. This dedicated compliance group has the full support of the legal department and direct access to HMC's Board of Directors.

Michael C. Bauder
Vice President & Chief Compliance Officer

John W. McCullough,
Senior Vice President & General Counsel

'10 in Review

Strong and trusting relationships allow us to carefully and confidently counsel the investment teams in their pursuit of investment returns. In other words, we have worked along side the Funds' investment teams for many years, we know what they do and how they do it, and we know how to support them in their efforts.

Investor Relations

HMC's number one deliverable to our investor clients is performance, plain and simple. Our number two deliverable is information. Information and communication are the responsibilities of the Investor Relations Group, a role we take very seriously at HMC.

The Investor Relations Group at HMC is the information hub of the firm, in continuous dialogue with investors, advisory firms, consultants and the world. HMC has eight investor relations officers located in our Birmingham, New York, Atlanta, San Francisco and London offices, providing global distribution and investor relations support to our clients. New to the team in 2011 are Rich Brereton in our New York office and Ken Freeman in our San Francisco office.

Each client of HMC is assigned an experienced financial markets professional as their relationship manager. The relationship manager is charged with all client servicing and communications regarding HMC and its funds. This includes assisting with the fund marketing subscription documentation, account funding, provision of ongoing performance reporting and fund updates. Should any client wish to meet in-person with a fund portfolio manager, this too, is arranged through the relationship manager. Our goal is to provide exceptional client service, comprehensive information and total transparency about HMC Funds to investors.

Information and communications are manifested in myriad ways. The Investor Relations team produces all fund marketing materials, maintains the HMC website www.harbert.net and publishes the HMC Annual Report. The team also prepares the fund performance reports, delivered to clients monthly or quarterly, and annually, as applicable. We are also proud of the firm's record in delivering annual K-1s and tax reporting material on a timely basis, and will endeavor to continue to do so.

Each year HMC invites Investors and professional colleagues to participate in the Annual Investor Conference in New York, the only day of the year when all of HMC's senior management and the portfolios' team leaders are together in one city. In 2011, the Harbert Investor Conference took place on March 2 at the St. Regis Hotel in New York City. The conference includes a series of rotating presentations on the performance of the various HMC Fund strategies and a report by Raymond Harbert on the firm's performance overall. We were delighted to host over 250 investors from around the globe at our 2010 conference.

Lynette P. Horton
Managing Director

Charles D. Miller
Executive Vice President &
Global Head of Distribution

Michael J. Larsen
Senior Managing Director

Melissa M. Babb
Managing Director

Alexis DuFresne
Director of Investor Relations

Rest B. Heppenstall
Managing Director

'11 Preview

HMC has eight investor relations officers located in our Birmingham, New York, Atlanta, San Francisco, London, and Melbourne offices, providing global distribution and investor relations support to our clients. New to the team in 2011 are Richard F. Brereton, Managing Director in our New York office and Kenneth M. Freeman, Managing Director in our San Francisco office.

In 2011, the Harbert Investor Conference took place on March 2 at the St. Regis Hotel in New York City.

Harbert Realty Services, Inc.

It may sound like an oxymoron to say we are a risk–averse developer, but that is what we are. We don't just develop property for the sake of making fees. We are cautious about what we do and feel confident that we'll be successful before we begin. Our size has been a benefit to us, as has the diversification of our business. While many brokerage offices concentrate on a few areas, we keep multiple arrows in our quiver, with services like asset management and leasing, to provide a steady, stable revenue for us in difficult times.

In March 2010, we closed on the acquisition of Rock Apartment Advisors, the premier multifamily brokerage firm in the Southeast. They bring vast experience, knowledge and deal flow to our business from an operating and revenue standpoint. As importantly, they provide us an entry in the multifamily real estate world, and complete our circle to be a full-service, all-discipline commercial real estate provider. Their 2010-2011 pipeline is filled with both market-driven deals, but also distressed asset sales. So we're excited about their contribution to our strategy, revenue and overall profitability.

Another highlight of this year is that we've been able to continue our development work, at a time when many companies are not able to do so. We have a couple of developments that are continuing to progress and in 2011, we'll start development on a $10 million grocery-anchored retail project in South Alabama.

Another activity we've been involved in this year is the medical and healthcare business. We've worked with a group called Med Vest Partners to develop our first asset in 2010, an urgent care facility in Athens, Alabama. We anticipate more activity with them in 2011, in both the development and acquisition of healthcare properties. This partnership allows us to capitalize on opportunities at street level for services, brokerage and smaller development projects. We see more of the opportunities driven from the healthcare changes mandated by the federal government.

Harry M. Lynch
President & Chief Executive Officer

Mary C. Echols
Executive Vice President of Financial Services

David R. Williams
Executive Vice President & Chief Operating Officer

'10 in Review

Diversity in service lines has allowed for continued revenue growth during the current real estate recovery cycle. Core management and brokerage assignments provided for steady revenue, while development opportunities have reappeared. Being a real estate industry survivor has created opportunities for distressed assets assignments from lenders and servicers.

Harbert Employees Reaching Out (HERO) Foundation

Renato Jurado was born on August 23, 2002, in Lima, Peru with spina bifida. His mother abandoned him when he was seven months old and his father died in 2005. In 2008, Renato's aunt and uncle brought him to Birmingham, Alabama and formally adopted him. Renato uses a wheelchair for mobility, but the house that his aunt and uncle own was not wheelchair-accessible. Children's Rehabilitation Services recommended Renato to the HERO (Harbert Employees Reaching Out) Foundation. HERO was able to provide a grant that helped build an access ramp to the family's home, a driveway extension and a wheelchair-accessible bathroom. This is one of the many ways in which the HERO Foundation reaches its goal of restoring a recipient's independence and self-sufficiency.

Renato's story reminds us that sometimes a helping hand can make a huge difference.

Though times are hard, even for the most fortunate among us, we cannot stop reaching out to those in need. That's why we created the HERO Foundation, to give our employees the means to help people in the communities where we live. Through the HERO Foundation, we provide direct financial assistance to people affected by natural disasters, medical conditions or temporary financial hardships. We help people get back on their feet and families stay together. Since 1998, our people, through HERO, have stepped in when no other help was available.

"HMC, as a company, employs a number of remarkable people," said Raymond Harbert, Chairman and CEO. "But the HERO Foundation shows that they possess more than extraordinary skill in their work. They also possess heart. You can tell from the pride with which they manage the Foundation and the effort they put into fundraising that they care about the lives of the people in their communities. Of all the things we do in this company, I believe our employees take the most pride in the accomplishments of the HERO Foundation."

During 2010, HERO awarded 27 grants totaling $143,000. The average grant was approximately $5,300. The Foundation is managed by HMC employees from throughout the company. The Foundation's resources come from contributions from employees, our affiliates and from fundraisers we hold throughout the year. Most of our referrals for help come from partners in the community, including Children's Hospital, Alabama Children's Rehabilitation Services and the Alabama Head Injury Foundation to name a few.

Management

EXECUTIVE OFFICERS

Raymond J. Harbert**
Chairman & Chief Executive Officer

Michael D. Luce**
President & Chief Operating Officer

David A. Boutwell**
Executive Vice President & Chief Financial Officer

William W. Brooke*
Executive Vice President & Managing Partner Venture Capital

Charles D. Miller*
Executive Vice President & Global Head of Distribution

Joel B. Piassick
Executive Vice President

Sonja J. Keeton
Senior Vice President & Chief Administrative Officer

John W. McCullough
Senior Vice President, General Counsel & Secretary

Thomas M. Hicks
Vice President & Director of Risk Management

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Vice President & Senior Managing Director

Alan C. Fuller
Vice President & Senior Managing Director

EUROPEAN REAL ESTATE

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Vice President & Senior Managing Director

Peter J.A. Land
Principal & Director of Investments

Private Capital

PRIVATE EQUITY

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Winston H. Gillum, Jr.
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VENTURE CAPITAL

William W. Brooke*
Executive Vice President & Managing Partner

Wayne L. Hunter
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MEZZANINE CAPITAL

John C. Harrison*
Vice President & Senior Managing Director

INDEPENDENT POWER

Wayne B. Nelson III
President & Chief Executive Officer

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AUSTRALIAN PRIVATE EQUITY

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Vice President & Senior Managing Director

Brendan J. Anderson
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Vice President & Senior Managing Director

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Heather N. Leonard
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EVENT OPPORTUNITIES

Neil B. Kennedy
Vice President & Senior Managing Director

VALUE

Todd D. Nunnelley
Vice President & Senior Managing Director

HARBERT REALTY SERVICES , INC .

Harry M. Lynch
President & Chief Executive Officer
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** Board of Directors Member*

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