A supplement to *The Institutional Real Estate Letter – North America*

THE INSTITUTIONAL REAL ESTATE LETTER – NORTH AMERICA

Sponsor Interview

Rockwood Capital

Recently, Geoffrey Dohrmann, publisher and editor-in-chief of The Institutional Real Estate Letter – North America, *spoke with* ***Peter Falco, Peter Kaye*** *and* ***Tyson Skillings*** *of Rockwood Capital. The following is an excerpt of that conversation.*

Peter Falco, Co-Managing Partner, is responsible for managing the corporate activities of the firm along with Walter Schmidt. In addition, Peter has oversight for Rockwood's Portfolio and Asset Management, Capital Markets and Legal operations. He is a member of the Investment Committee and chair of the Portfolio and Asset Management Committee.

Peter Kaye, Managing Director and Partner, is the Portfolio Manager for Rockwood Funds V, VII, and the firm's core separate account. Peter is a member of the Investment and the Portfolio and Asset Management Committees.

Tyson Skillings, Managing Director and Partner, is the Portfolio Manager for Rockwood Funds III, IV, VI and VIII. Tyson is a member of the Investment and the Portfolio and Asset Management Committees.

Rockwood wrapped up two 10-year funds, Fund III and Fund IV, last year. How was the investment climate for those funds similar to or different from the environment today?

Skillings: Real estate faces cyclical challenges, and correlations can be drawn between the investment periods for III and IV and where we are today. Specifically, Fund III was a 1998 vintage fund that we invested during the strengthening tech-boom economy, which has distinct similarities to the burgeoning economy of 2005–2007. Conversely, Fund IV was a 2000 vintage fund that was invested during the 2001 recession, so a climate similar to — though not as severe as — today's. Investing in this economic climate requires patience and discipline. In both Fund IV and Fund VIII, there was a time early in the investment period when we didn't make any investments. In Fund IV, we requested and received a 12-month extension from our investors because we saw a strengthening investment leading into 2003. Our Fund VIII, which was raised in 2008, is following a similar investment pattern. In the early stages of the downturn we exercised patience to avoid investing in "perceived value" as the first of many price reductions hit.

Falco: This obviously isn't the first time we've been investing in the downside of the real estate cycle. We have a very experienced team that has worked through a number of different up and down cycles — some of us count this most recent downturn as our fourth. In fact, every fund will probably find itself in both up and down times during its life. A fund isn't just asset selection; it is also managing and adding value to those assets while watching for the best time to exit, all of which typically covers about a 10-year period. During this time, you are most likely going to encounter one, if not two, down cycles driven by a financial crisis or supply/demand imbalance, or both. So you have to be prepared for that and manage your portfolio with the expectation that you will have a period of dealing with very difficult circumstances. Based on our experience with the downturns of 1989–1994, 2000–2001 and now 2008 to "who-knows-when," we know you need to be patient. During the down cycle, there seem to be opportunities, but there is also tremendous risk, as the market is declining, and it is very hard to know where you are in the down draft. We have found that instead of leaping at these supposedly once-in-a-lifetime opportunities, patience is more often rewarded. For example, our first commingled fund was invested in the very early part of the recovery of the 1989–1994 cycle. It had great returns, but they ended up lower than those of the funds invested later in the recovery cycle. There was simply more and better financing available later in the cycle and, frankly, more opportunities. We're seeing that same thing happen this time in investing Fund VIII, where there is certainly more opportunity surfacing now than in the 2008–2009 period. We expect to see even more opportunity next year as the market loosens up and people start to recognize the true value of their positions and the extent of impairment, and become realistic about selling the assets at market.

If you're looking back at Funds III and IV, what were the most successful investments that you made?

Skillings: One of the most successful investments in Fund III was University Circle, which is located in East Palo Alto, Calif., on the west side of Highway 101 and University Ave. In 1999, we assembled a 12-acre site comprised of numerous parcels with our local partner. It was the first significant redevelopment in the area. We entitled and developed three, six-story, class A office buildings totaling about 450,000 square feet. We also had one hotel pad that we elected not to develop ourselves, but rather sold to a hotel developer who built a Four Seasons. This project had very strong pre-leasing, then experienced significant adversity brought on by the 2001 recession that devastated the tech industry in Silicon Valley. We lost tenants, including one of our the main tenants, a law firm that filed for bankruptcy. But the quality of the location and building won out, allowing us to generate strong leasing activity at a time when fundamentals were lousy. Ultimately we sold into the strengthening economy in 2005 and created a strong profit and multiple for the fund.

Kaye: I'd say another big investment for Fund III was our data center investment, which also went through the tech down cycle and suffered through a major full tenant bankruptcy of what had been a rated company. This is a facility in downtown San Francisco that started out as a fully occupied building producing $5 million of NOI, and became a fully vacant building. Working closely with our partner, and through proactive asset management, we were able to bring that building back from being a part of the tech wreck of the early 2000s to being one of the premier, fully leased assets in the data center community in San Francisco, and we ultimately put back in place $21 million of NOI, an extraordinarily successful investment for the fund. Both of these examples illustrate the importance of quality — be it location or building — and patience. Because we invested in quality assets and had the patience to wait for the cycle to turn, we were rewarded handsomely in both cases.

Have you had to make any changes within Rockwood to deal with today's investment climate?

Falco: This downturn has required a tremendous amount of focus and work to structure our portfolios, support our property investments and restructure debt. To deal with that, Rockwood figuratively divided itself into two parts. We separated our Portfolio & Asset Management functions from our Acquisitions group. We also appointed or brought in heads of each asset type so we have deep expertise in residential, retail, hotel, office and — what is for us a fifth property sector "food group" — the data center world. The downturn focused our attention on the day-to-day work of making sure that our tenants are happy, that we are doing everything we can do to lease up properties, and that we are fully capitalized. That is the job of the Portfolio & Asset Management team. At the same time, we have to remain optimistic that both the real estate and capital markets will recover, and be looking for opportunities. One of the big challenges of any investment firm is to counteract the natural tendency to be too positive in the good periods and too negative in the down periods. The separation of our asset and portfolio management decisions from the acquisition decisions should help us keep the right balance. The investment committee literally discusses them on different days!

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Have you been buying at all?

Falco: We are now. During the latter part of 2009, as we began to see the bottom in certain markets and product types, we began buying and have continued to carry out that program through 2010. We are seeing some great opportunities right now.

What is going to be your strategy for investing in the up cycle when it comes, and how is that going to be different from how you're investing in the down market?

Skillings: Fund VIII is in the middle of its investment period right now, so it's spanning the down cycle and moving into what should be better days ahead. Early in the fund investment period, when values were free falling, financing was unavailable and liquidity was essentially nonexistent, we focused on finding assets with distressed ownership but existing cash flow. If you look at the first three assets we bought for the fund, all of them are strong cash generators. Now that we're seeing some markets bottoming out, we are more aggressively underwriting risk, though still with discipline. So as the market is showing signs of stabilization, we're going to take more vacancy risk and targeted development risk. For example, we'll look at urban infill development opportunities or development with full entitlements that we can acquire at a significant discount, so that as the market comes back, we can be the first ones to deliver into the market upswing. We are also focused on targeting investment opportunities throughout the capital stack, so not only originating on the equity front, but also looking at acquiring distressed debt positions as a way to get to the real estate.

ABOUT ROCKWOOD CAPITAL

Rockwood Capital is a private real estate investment firm that currently is managing more than $4.2 billion of equity commitments on behalf of high-net-worth individuals and more than 90 public and private institutional investors. For the past 17 years, Rockwood Capital has been a trusted equity joint venture partner with outstanding real estate entrepreneurs investing and adding value to all types of real estate, including urban and suburban office, research and development, biotech, data center, neighborhood and regional retail, urban and suburban hotel, apartment, condominium, resort and single-family property.

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What are the key risks that you're underwriting, and how are you mitigating those risks?

Kaye: We are constantly revising our strategy and challenging our assumptions on the underwriting. We have a sizable existing portfolio that really gives us keen insight into a very broad base of investments at a micro level. We're trying to take the best of all those investments and factor them into the underwriting as we look at new investments. The challenge is to be as realistic as you possibly can, while also trying to really price risk appropriately. We're always trying to take advantage of arbitrage when we can, but underwriting the risk really comes from underwriting our existing portfolio, as well as monitoring the drivers of the market on a more macro basis.

What are those drivers?

Kaye: We look very closely at where U.S. firms are locating their labor and growing their companies, and what markets are seeing the benefit or the detriment of that growth. We're seeing stronger growth than normal in some of the technology-based markets, where cash-rich companies have started to invest in R&D locally, and that's increasing demand on the office front, as well as flowing into other sectors. Manhattan is the most global city we have in the country, and you're seeing some of the benefits of that as we've seen early recovery throughout just about every sector in that market. To the extent that some of the cities in the U.S. become increasingly global over the next 10 years, we'll continue to see outsized returns in those markets. That's why we typically stick to our core markets, which would be the gateway markets of the Northeast — Boston, New York and Washington, D.C. — as well as San Francisco and the Los Angeles region. We will invest in Seattle, South Florida and even the Phoenix area as high growth markets, but really our core markets are where we see the biggest impact of a global workforce and global profitability over a longer period of time. We couple that with the demographic trends showing the population of the U.S. increasing by 25 million people over the life of our new fund, and we feel that several sectors, particularly the residential sector, should see significant increased demand.

What's been your strategy for returning value on assets that you've been struggling with because of changes in the environment?

"We're very careful to protect the resources and liquidity of the fund and the portfolio. We have a mantra that goes back years and years — DROOC, Don't Run Out Of Cash."

Falco: Any investor who held property going into the late 2007 though 2009 period has seen the effects of the maelstrom. Clearly operating income has declined, values have declined, and the liquidity crunch has really created some issues for owners of property. For a value-added investor such as Rockwood — where the typical asset business plan often calls for a relatively short hold of a non-income-producing asset while we are repositioning, releasing or developing it — the question becomes: how do you get through the downturn when your assets by definition don't have much cash flow and your hold period has been lengthened due to a lack of liquidity? In a downturn of this magnitude, some of the emphasis is simply on survival, so that when the market returns you can again start to carry out your business plans and value-add programs. To get through those down periods, Rockwood looks at each fund as its own standalone entity and business, and it manages all of the investments as an aggregation of assets. We're very careful to protect the resources and liquidity of the fund and the portfolio. We have a mantra that goes back years and years — DROOC, Don't Run Out Of Cash. That mantra dates back to our heritage of coming through the 1989–1994 downturn, but it's something that has stayed with us and that we followed in the 2001 downturn, and it certainly came in handy in this downturn. By watching the cash, we had the resources, the reserves, and ultimately the ability to reset virtually every one of our assets. We were probably the first real estate manager to go to our lenders and ask for a five-year extension, which has given us a lot of running room — years in fact — to benefit from what we all expect to be a long recovery cycle.

With respect to specific assets, it's critical to look at them with a cold eye. Some assets we realized were mistakes, and we had to be willing to cut our losses. On the other hand, when we've invested in a good product in a place where people want to live or work or play, we have to have faith that it will recover. This is when it's critical to have the capitalization to get through the downturn so that as things do get better, we can benefit and see the kind of value increases and recoveries in operating income that we are now seeing in our properties in Funds V, VI and VII. In fact, we are already beginning to move away from simply conserving cash in one of our multifamily portfolios to again making improvements to units because we've reached the point in the cycle where those value-add activities can again produce results.

Now that we're beginning to move forward, are there any sectors you particularly favor?

Kaye: We typically target and invest in office, hotel, residential — both "for-rent" and "for-sale" — and retail. We also have a history in data centers. We try to stay within those property sectors, and we're still looking for new investments in each of those sectors today. Those investments might be distressed real estate, real estate debt or just straight up equity — we're really canvassing all of those sectors. In the office and hotel sectors, we're very active in each of our markets. We have sizeable portfolios of each in just about all of the core markets, so we have a very strong pulse of exactly what's happening on the ground, which is very beneficial for the acquisition of new investments. Although we liquidated our data center portfolio, we still believe that they have very strong and solid fundamentals, so we are actively pursuing investments in that sector as well. On the debt side, we are seeing some very interesting opportunities to originate or buy debt that is forecasted to achieve equity returns. In such cases, you're getting a more protected position in the capital stack for equivalent returns, a much better risk-adjusted return. To the extent that we can continue to do that, we will, whether it's in more of a core-plus strategy, where we have very good sponsorship, a great yield and very protected position on the debt side or in a distressed situation, where we may be able to get at the asset and eventually own it outright.

Has the downturn caused you to change your strategy in any way?

Kaye: No. However, like everyone, we have been reminded to factor in the true implications of risk. We plan to stick to our knitting in terms of product type and market. On the core/core-plus side, we really favor gateway markets and assets in the locations that we know very well. Over the next 10–15 years, we expect those cities to rise to the top based on their role as global cities with a focus on technology and human capital. Over a long period of time, we're clearly looking for urban mixed-use projects where, whether it's hotels or urban residential or prime retail or office, we feel the capital flows will continue to migrate. We've learned that the quality of the location and quality of the asset enable you to have pricing power over a long period of time, and that's really what we look for in core/core-plus investments.

Skillings: We've built our firm on executing a value-add investment strategy through commingled funds, but recognize that investment strategies evolve over time. It's a fairly fluid process and we're constantly evaluating our investment strategy to manage risk by focusing on property and geographic mix. In early funds, Rockwood primarily focused on value-add office investments. However, over the past decade we've diversified our property sector focus and have hired expertise in retail, hotel, residential and data centers, which has allowed us to diversify our portfolio risk. We have a hub-and-spoke strategy, where within our primary markets we're investing in multiple property types.

You mentioned you're strengthening your staff. I understand you recently appointed a new director of hotels. Is that signaling a priority focus on the hotel sector that's different from what it was in the past?

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Falco: Adding the director of hotels is finishing something that we started about two years ago in response to what we saw coming up in the industry. Unlike many real estate firms, Rockwood actually grew over the past couple of years. We went into this downturn with about 65 people. We now have 85 people. I think we're probably one of a few real estate firms to have hired and increased not only our number of staff, but also our level of expertise. So even though our assets under management for the period 2007–2009 remained steady, we increased our staff because that's what it took to do all of the work associated with restructuring and repositioning our existing funds to come through this downturn while investing the $964 million raised in Fund VIII. It made a huge difference in the outcome for each of our existing portfolios, and we expect that to be evident in the future as the market recovers.

What would you like Rockwood to be known for 10–15 years from now?

Falco: I would like Rockwood to be known for two things: integrity and tenacity. Integrity goes to the responsibility that we feel to our investors. Our investors are not just looking for financial returns. Our investors ultimately constitute retirees and their retirement dollars, or endowments and foundations where the money and the resources are going to fund educational programs or build additional research facilities. We take a loss very personally because it isn't just about money; it's about the things that our investors want to accomplish with their resources. We, of course, try to get every investment right, but we think that what's truly critical is what happens when unforeseen events occur. This is where integrity meets tenacity. In the downturn, Rockwood didn't shrink. The people at Rockwood stayed and worked hard on all of the assets, and we brought everything we had to bear on all of our investments. We brought the basic real estate expertise, we brought our capital market knowledge, we brought a huge set of relationships in the industry, we brought our legal acumen and a little bit of toughness to all of our restructurings, but most importantly, we brought the tenacity to work through all of the problems.

Skillings: We want to be known as disciplined investors. We use the words patience and discipline a lot, and there's a reason for that: we stick to our markets, we stick to our product expertise, we don't try to be all things to all people. Also, we have a collaborative culture; we work as a team. We tackled issues proactively together as a team and emerged a much stronger firm.

Kaye: I'd like Rockwood to be known as a firm that has deep respect and accountability. We respect our investors as well as ourselves. That respect has enabled Rockwood senior partners to stick together through all of the market cycles over the last 30 years. This respect we feel for our investors and our team is manifested in the deep responsibility and accountability for what we do on a day-to-day basis. That says a lot about the people that you're dealing with. Rockwood has a deep desire to perform for the people who support us — our investors — and be a very disciplined investor with integrity and tenacity to ride out the cycles for their benefit. ❖