KTR Capital Partners

Recently, ***Geoffrey Dobrmann,*** *publisher and editor-in-chief of* The Institutional Real Estate Letter – Americas, *spoke with* ***Bob Savage, Steve Butte, John DiCola*** *and* ***Don Chase*** *of KTR Capital Partners. The following is an excerpt of that conversation.*

Robert Savage is Senior Partner and President at KTR Capital Partners. Prior to founding KTR, he was Executive Vice President, Chief Operating Officer and a Trustee of Keystone Property Trust until its sale in 2004. He was a partner in the formation of Keystone in 1997 and joined the firm in an operating capacity in November 2000. From 1997 to 2000, he was a Partner at Hudson Bay Partners, a private equity firm. Previously, he worked from 1994 to 1997 in the Investment Banking Division at Merrill Lynch & Co.

Donald Chase, Partner and Co-Head of Investments, is focused on development and alternative investments and serves on the company's Investment Committee. Prior to this role, he oversaw acquisitions and developments throughout the Southern and Western United States. He served as Senior Vice President of Investments at Keystone Property Trust, overseeing acquisitions and development in the mid-Atlantic and Midwest markets. Prior to joining Keystone in 2002, he was the Director of development at TIG Real Estate Services.

John DiCola, Partner and Co-Head of Investments, is responsible for direct investments, with oversight of all acquisitions and development activities throughout target markets across North America and serves on the company's Investment Committee. He served as Senior Vice President of Investments at Keystone Property Trust from September 2002 and was responsible for overseeing acquisitions and development in the Northeast. Prior to joining Keystone, he was Principal and co-founder of Triad Partners.

Stephen Butte, Partner and Head of Asset Management, is responsible for leasing, dispositions, and overall portfolio management of the company's portfolio and serves on the company's Investment Committee. Previously, he served as Senior Vice President of Asset Management at Keystone Property Trust where his primary responsibilities included overseeing all portfolio and property level analysis for Keystone's existing portfolio as well as proposed investments. He has been involved with KTR or its predecessors for his entire real estate career beginning in 1988.

You guys recently raised $1.2 billion for your third fund, quite an impressive raise. Why do you think you were successful in raising that much capital in what has been a challenging fundraising environment?

Bob Savage: First and foremost, investors found our ability to create value with our operating platform at the real estate level compelling. We have 75 people in seven vertically integrated offices across the country today. Secondly, our strategy has remained consistent since we started. We focus on investing in industrial assets in major markets, especially infill submarkets, targeting highly functional assets and ownership at a basis where we can compete for tenants regardless of the market conditions. And, lastly, our track record is strong. With Funds I and II, we have demonstrated that we preserve capital in down markets, yet we have been able to generate outsized returns in the industrial space during favorable investment cycles.

Steve Butte: In effect we are able to combine the knowledge of a local operating partner with an institutional-based financial sophistication and risk management in one organization.

Compared to other industrial property investment managers, what do you see as unique or distinct about your particular strategy?

John DiCola: In the industrial market today, most investors are evaluating risk according to income stability, and that means capital is mainly focused on current return associated with well-leased properties. That leaves less competition in the value-add space, where spreads currently are at a historical high versus core, and so the margins are attractive. As a value-add investor we are total return–oriented and we see risk as a function of price. Our overall strategy is to buy the most functional real estate at an attractive basis, allowing us to compete for tenants to fill vacant space quickly. Then once we have a stabilized asset, we can turn around and sell it into that strong core market. The vast majority of our deals are done off-market. As an active operator, we are intimately involved in our markets, which allows us to find deals in major markets where there are high barriers to entry. Lastly, we are now in 21 markets across the country, and we are increasingly generating more of our business through our existing customer base, often working with tenants that are in multiple markets where we have a presence.

Markets have been changing; how have you changed the implementation of your strategy accordingly?

Don Chase: Our value-add strategy has never really changed. Basis has been incredibly important since we started investing in industrial 16 years ago. But we have been able to adapt tactically in response to changing market conditions. In the 2008–2009 period, we geared our deal team to focus on alternative investments, acquiring debt positions and looking at other distressed investments, and we were successful doing that. As the market has begun to recover, we have shifted some of that emphasis to the development side, both build-to-suit and speculative development.

How would you describe the current environment?

Savage: The investment environment overall is pretty attractive today for the simple reason that fundamentals have continued to strengthen, even in a modest economic growth environment. The sector is only in the early stages of new supply being a factor on a speculative basis, so the operating environment overall is favorable. There is capital out there, but it is predominantly focused on stable and income-producing properties. We are able to dispose of the assets in Funds I and II into a fairly robust core market, and we are able to allocate capital into the value-add space for Fund III where capital is relatively scarce. There is not an abundance of financing for unstabilized properties, and there are few equity platforms that execute a similar strategy to us. The real bargains and the environment that persisted while we were investing Fund II have changed to a more mature, later stage of the recovery cycle, but it is still quite attractive, and we feel overall the opportunities in front of us are compelling.

Being able to deploy $1.2 billion is different than raising it, and that is what you are faced with now. How do you plan to source deals?

DiCola: We have a 14-person investment team, and we pride ourselves on being local in our market knowledge and our execution, so our team is expected to be in our markets everyday, meeting with brokers and tenants on a constant basis. Our goal is to know our markets intimately, street by street, building by building. In that fashion we are able to target properties off-market and uncover opportunities that are not readily apparent to others who may be sitting behind their desks. It helps that industrial is still unique among property types in that leasing brokers will often act as investment sale brokers and developing strong local relationships on the property level allows us to see a lot more opportunities. The network we have developed in this regard is a huge asset.

Why does sourcing deals off-market matter? Why should investors care?

DiCola: Every year, we look at all the deals we have completed, and typically those sourced in a direct fashion result in better returns. Here is an example of how a deal is generated off-market: if we are in the market and talking to a leasing broker, we may ask how their experience has been with a particular asset. If we find out that the current owner is not able to respond aggressively and the proposals they put out don't provide for tenant improvements, then that's a sign there is an opportunity. So through that leasing broker, or maybe directly, we will target that property and make an unsolicited offer. This is exactly what happened recently with an attractive property in a first-tier market that we discovered was underwater and the lender was in workout mode with the owner. We contacted the lender, who was interested in finding a quick solution and did not have the time or the inclination to put the property on the open market. We structured a deal to buy the note and then quickly arranged a deed in lieu transaction with the buyer that allowed us to acquire the asset at an attractive basis. From an operating standpoint, the property had nothing wrong with it, but it was lacking the capitalization that would allow it to compete favorably in a competitive leasing environment. In that case, we were able to acquire a high-quality property that, had it been brought to the market, would have traded at a much higher price.

What is the advantage of doing business that way?

DiCola: The advantage is you are uncovering opportunities in a noncompetitive fashion. By being a solution provider for value-add situations, you create a well-defined path that you can communicate to a seller or a lender, a quick and efficient way out of an undesirable position. Very often, they are more than willing to engage in that type of conversation, and you increase the chance to acquire a property at a lower price than would be possible if it were turned out onto the open market. By avoiding competitive situations, we also don't waste time pursuing deals that get away from us on price.

Savage: Historically, 65 percent to 70 percent of our investments have been acquired off-market, which should not be confused with a broker not being involved. I would say a broker is involved in 90 percent of the cases. It is the ability to transact in a noncompetitive fashion that allows us to invest efficiently and effectively, not the absence of brokers, that makes off-market deals attractive.

Can you give a couple other examples of off-market deals?

DiCola: About 10 months ago we acquired a functional, 180,000 square foot building in an infill market in Southern California. We were taking advantage of discounted values for Class B assets in the South Bay Port District of Los Angeles that had resulted from a widening spread between Class A and Class B rents. This property was owned by a major institution, and they had renovated the building at the height of the market, at close to $100 per square foot. When the downturn occurred, they had trouble leasing it at their targeted rent and found themselves chasing the market down. After they spent a few years unable to find a tenant, we were able to buy the property at 75 percent of the value that they had invested in it. This is a case where being close to what is happening on the ground was important; we kept in contact with the owner to see where their mindset was and repeatedly asked if they would be willing to sell. For two years, the answer was no. At the end of that last year though, they were the ones who called us and said yes. At a reduced basis, we were able to engage the market at much more reasonable rents, and we recently leased the entire building at rents 7–10 percent above plan. As another example, three months ago, we closed on a 19-building industrial park totaling approximately 2.8 million square feet in the heart of the Seattle market. This was an opportunity to reposition a well-located business park that was in need of meaningful capital investment to address deferred maintenance and a depleted rent roll. The current owner was willing to sell rather than face the challenges of re-stabilizing the asset. This was a deal that was brought to market a year ago, and they were not able to get interest at the pricing level they were looking for, then they suffered through a year of challenging efforts to try to get it stabilized. We circled back to see what their mindset was and if they were willing to engage in a discussion to sell it off-market. It helped, and this is another distinct advantage that we have, that we can move very quickly. In this case it was a $170 million deal that we completed in essentially three weeks start to finish. Not only due diligence, but in that timeframe we were able to develop a comprehensive repositioning plan to invest $20 million to re-establish the project as a high-quality image park in the marketplace. We closed on this in June, and since closing we have already completed 60 percent of our designated improvements and have signed five leases representing about 290,000 square feet at lease economics in-line with plan. We also have another 25,000 square feet of additional leases that are in active negotiations.

When you close in a short period of time, how do you make sure you don't miss something important in the process?

DiCola: That again goes to a distinct advantage of having a full-service, integrated operating platform that is brought into the process as we are underwriting and completing our due diligence. Each deal team involves not only the investments officer, but also the asset manager and property manager who will be responsible for the asset once we take title. Typically, at the time we bid on an asset, that whole team has already walked through the building and has very realistic assumptions about what it will cost to address deferred maintenance, as well as position the asset in a competitive marketplace. We also, as a team, collaborate on underwritten rents relative not only to our sense of the market, but what we are experiencing within our own portfolio. We are able to move quickly as a coordinated, multi-disciplinary group that makes sure we don't miss anything.

What do you see as a main advantage to having a vertically integrated platform?

Butte: Multiple direct touch points with tenants enhance our ability to recognize and solve issues before they threaten our relationships. A vertically integrated platform helps us build those relationships by enhancing our reputation as problem solvers, which ultimately benefits our national portfolio. It can be seen through our organic growth within our portfolio, evidenced by more than 3 million square feet of new leases with existing clients in the past 18 months. The early involvement with the underwriting process by asset management and property management also creates a sense of accountability and ownership over the business plan within those two groups. I believe we have a reputation for being the best provider in the markets where we have property management and asset management on the ground. Further, when we acquire assets, the market recognizes the change we make by bringing our focus to that asset versus an out-of-market, institutional owner that hires a third-party manager, a third-party leasing agent and visits the market once every few months. That is just not how we do things. We are hands-on, watching every asset all the time.

What about flexibility? If someone with a third-party manager leaves a market, they just sell the property. But when you own the infrastructure in place and you think of leaving the market, you are basically leaving some of your best people on the ground. How do you deal with that?

Butte: We self-manage about 70 percent of our assets, and they are in our major markets. We are still using third-party managers in the balance of the markets, where we don't have critical mass, but those third-party managers are run by overall supervision from our asset management and property management staff. For example, if we sell 2 million square feet in Chicago, we are not going to have to lay anyone off because we have a permanent presence there, even as properties come and go. We are going to do other acquisitions in Chicago on behalf of future funds, so we need to keep a solid team on the ground. We are also constantly reviewing where we are in different markets and where we can start to leverage off our ability to put people on the ground in the future.

What are you doing on the development side today?

Chase: We have a fairly robust development pipeline at the moment, dominated by build-to-suit development. We have about $200 million worth of build-to-suit projects that we expect to close before year-end and begin construction. On the speculative side, we are really picking our spots and looking at opportunities that we can complete within a market cycle. We are not looking at

CORPORATE OVERVIEW

KTR Capital Partners is a real estate investment, development, and operating company focused exclusively on the industrial property sector in select markets throughout North America. Since December 1997, the KTR team has completed over $5.7 billion of acquisitions and development. KTR is a recognized industry leader directly sourcing, proactively targeting and creatively structuring industrial real estate investments. KTR's current investment vehicle — the $1.2 billion KTR Industrial Fund III LP — provides approximately $3.5 billion of investment capacity focused on value-add investments in the industrial sector.

long-term, multi-phase development projects. A great example of a spec development we have under way right now is in Central Los Angeles. It is essentially a redevelopment, but will be a new, 36-foot clear-height, 600,000 square foot building in the heart of the Commerce market. We acquired the land about 18 months ago and went through a significant environmental remediation and removal of an old facility. We are about to tilt walls on that building and deliver Class A product into a market that rarely sees it at that size. We feel it is a unique asset within the biggest and most important industrial market domestically. We have had a lot of early interest in the building from users who haven't seen similar offerings, so that is an example of where we are taking advantage of an opportunity to put all of our skills to work, get through a complicated site and put speculative product in place.

Can you explain how e-commerce is impacting the industrial sector?

Chase: I think e-commerce is currently the largest factor affecting the design, location, demand, etc., of industrial property throughout the United States. The market is experiencing a structural shift from a regional/super-regional model which supplied stores, and in which retailers or consumer products companies were generally able to locate those facilities in proximity or amongst those stores. By contrast, the e-commerce clients' priority, first and foremost, is speed. They want to be able to reduce the time from click to ship and then from ship to doorstep, so they are looking for real estate that is closer to the consumer. The size and shape of those buildings really varies depending on how many different products are being supplied out of the facility, but what we have seen is that the demand from e-commerce tenants has been mainly focused on newer facilities and, a lot of times, build-to-suit facilities. These companies are putting so much money into the technology and the infrastructure within the building that they have to make a long-term commitment, and so they want to do that with the best facility. The other factor driven by e-commerce that is changing the design and location of facilities is that the employee population within these facilities is growing, meaning large parking areas and proximity to public transportation and a quality labor base.

What is your philosophy for risk management in general and with respect to the utilization of leverage?

Butte: We believe risk is primarily a function of price and not income stability. We are hyper-focused on basis and functionality, so we can provide good value and take market share in a down market. For example between the first quarter of 2009 and the second quarter of 2010, the industrial sector lost over 140 million square feet of aggregate demand and went from 9 percent vacant to 11 percent vacant, yet over the same time period our portfolio went from 75 percent occupied to 87 percent occupied. Despite that massive contraction in demand, we were still able to stabilize our portfolio and preserve investors' capital because of our emphasis on acquiring well-located properties at the appropriate basis.

How does leverage play into that equation?

Savage: Portfolio construction factors into our leverage approach. We are mixing stable, income-producing assets with unstabilized assets all the time to create an overall reduced risk profile for the fund, and that creates a more financeable portfolio. Our approach to leverage is to balance flexibility with managing future interest rate risk, so at any given time approximately half of our portfolio leverage comprises long-term, fixed-rate debt and the balance is shorter-term, floating-rate debt. The pool of assets included in the shorter-term, floating-rate loans are constantly in different stages of stabilization. When a pool of those assets has stabilized and the value has been created, we will take it out and finance it with longer-term, fixed-rate debt. Then, if we need to sell assets out of those fixed-rate pools, we have substitution rights and can take either unencumbered assets or assets from the floating-rate pools to use as substitution. We tend to manage the balance sheet more like we did when we were a public company where we had leverage concentrated in the stable assets.

Where do you see your firm two to five years from now, and what will you be doing then?

Savage: Our intent is to continue the strategy that we have been executing in the industrial sector with Fund III and future funds as well. A focused strategy has served us and our partners well. We think the knowledge we have in this space is second to none, and we expect to continue to take advantage of that. Our approach is increasingly customer-centric. That is leading to better performance operationally, doing business on a repeat basis with customers in different markets who have a favorable view of KTR. We have just had a successful fundraise in a very traditional structure and with a typical cross-section of institutional LPs, but it is undeniable that the sources of capital and the vehicles in which they prefer to invest will continue to evolve. We view it as critical for our business to continually monitor and evaluate those trends to maintain access to the deepest pools of capital. ❖

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