THE INSTITUTIONAL REAL ESTATE LETTER – AMERICAS

Sponsor Interview

Carmel Partners

Recently, ***Geoffrey Dohrmann,*** *publisher and editor-in-chief of* The Institutional Real Estate Letter – Americas, *spoke with* ***Ron Zeff, Michael LaHorgue, Don Campbell, Chris Beda, Quinn Barton, Dennis Markus*** *and* ***David McWhorter*** *of Carmel Partners. The following is an excerpt of that conversation.*

What is the history of Carmel Partners?

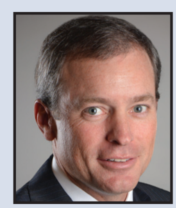
Ron Zeff: We were founded in 1996, and until 2003 we were a sector-specialist JV partner/operator in multifamily renovation and development investments with some of the leading institutional "allocator" investment managers, at that time primarily in California and Colorado. During that period, we invested in approximately $1 billion of multifamily assets and were recognized by those managers as a top performing JV partner. It was during this time that we developed our institutional reporting capabilities. In 2003 we shifted to a vertically integrated investment manager platform with in-house operational, development and construction capabilities and formed our first institutional fund offering. We were fortunate to have several leading endowments and foundations as founding investors in our U.S. multifamily "value creation" fund series. We've always been principal-oriented investors, not merchant builders, so the fund structure appealed to us.

David McWhorter: It allowed institutional investors for the first time to access Carmel's capabilities directly rather than through "allocator" managers. One of the reasons investors are attracted to Carmel is our sector specialization in U.S. multifamily and our platform that allows us to execute investment strategies without a JV partner. Our fifth value creation fund closed in July after only nine months in the market. Fund V reached its hard-cap of $1.025 billion and was oversubscribed. We have a history of strong support and a high re-up rate from our existing investors with more than two-thirds participating in multiple funds. We were also

Ron Zeff founded Carmel Partners in 1996 and currently serves as Chief Executive Officer. He is also chairman of Carmel Partners' Investment Committee. He has 27 years of real estate experience. Previously, Zeff was a partner at Trammell Crow Residential in San Francisco.

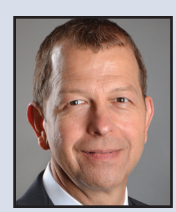
Michael LaHorgue is Senior Managing Partner and President. He oversees all day-to-day activities of the company. As President, LaHorgue also serves as a member of Carmel's investment committee and executive committee. He joined Carmel in 2014 and has over 30 years of institutional and private real estate investment experience, including serving as President of Shorenstein Realty Services before founding Seaview Ventures in 2002.

Donald Campbell is Senior Managing Partner and Chief Operating Officer. In this capacity he serves on the Investment Committee. He is responsible for daily operations across all investments. He has 30 years of real estate experience. Before joining Carmel Partners in 2002, Campbell was the Managing Director of Finova Realty Mezzanine Capital.



Christopher Beda is Senior Managing Partner and Chief Investment Officer. In this capacity he serves on the Investment Committee. He oversees all aspects of the firm's investment and disposition activity. Beda has 24 years of real estate experience. Before joining Carmel Partners in 2004, Beda was the acquisitions and dispositions officer for the western United States at Equity Residential.

Quinn R. Barton III is Managing Partner, Capital Markets, and leads the firm's multifamily debt investment activities. In this capacity he serves on the Investment Committee. He heads up the firm's Manhattan office and has 22 years of real estate experience. Prior to joining Carmel Partners, Barton was a Managing Director and head of CMBS trading for Bank of America Securities in New York.



Dennis Markus is a Managing Partner and Chief Financial Officer. In this capacity he serves on the Investment Committee. He is responsible for accounting, FP&A, project finance and compliance. Markus has over 20 years of experience in the real estate and financial services industries. Prior to joining Carmel Partners, Markus was CFO and President of Larkspur Hotels and Restaurants.

David "Mac" McWhorter is Managing Partner and Head of Investor Relations. He also serves as a member of the firm's Investment Committee. McWhorter has more than 30 years of institutional real estate investment experience. Prior to joining Carmel in 2013, McWhorter was the Director of Investor Relations for the western United States at AEW Capital Management for over 10 years and served as the firm's U.S. public funds market specialist.

successful in attracting a select group of new investors in Fund V that totaled approximately $200 million in commitments.

When you were shifting to a value-added/opportunity fund, what objectives were you trying to accomplish?

Don Campbell: When we were raising capital for individual deals, we had to put energy simultaneously into both raising the capital and finding and establishing the business plan for the individual deals we were pursuing. The fund platform allows us to raise capital up front and then direct our organizational focus to executing the business plan. Our attention can focus on finding the best possible deals and executing those deals after we acquire them, as opposed to trying to find capital at the same time we are trying to tie deals down.

Zeff: And discretionary capital can help us win deals in the marketplace. It allowed us to be more competitive in the marketplace and move faster on transactions. Of course, in 2006–2007, having discretionary capital was less advantageous. There were so many sources of capital that discretionary capital was not a competitive advantage. However, today it has become a real advantage for us as we are able to move very quickly on deals.

What changed when you moved from being a joint venture partner to an institutional investment management platform?

Zeff: It really wasn't a large shift because we were always very principal-oriented investors. The main benefit was focus. We try to be the very best in every aspect of our business. We really pride ourselves on the detailed underwriting we do on every deal, and how thorough we are in the acquisitions process. We try to be best in class with our investors and provide a lot of transparency. We're trying to deliver top performance, and having the funds allows us to invest in our people — attracting and keeping top-quality talent.

Chris Beda: When I joined the firm in 2004, it was at the beginning of the transformation to a funds capital structure. It is a very fair capital structure that is able to move through a full real estate cycle and have the resources to capitalize on opportunities when they arise, but also have the longevity to survive.

Zeff: One of the things that separates Carmel from other firms that focus solely on renovations is that we come out of a development background. I think most value-add managers don't take a new construction approach to their rehabs, but we do.

Carmel Cos. was a big Denver-based developer that operated multifamily properties. Is that firm in any way related to this firm?

Zeff: My father founded what was ultimately called Carmel Cos. in Denver in 1964. Carmel Partners is a separate company, but the name Carmel recognizes my heritage and the values that my father represented in building his business in Denver. In fact, the name Carmel comes from an experience he had on Mt. Carmel in Israel during his military service. My father was an American success story. He emigrated from Israel and obtained his master's degree in engineering at the University of Colorado. He eventually went into the apartment business in the 1960s and over time became the largest multifamily owner in Denver, which he developed entirely on his own without any institutional partners. He never sold any assets, and as a result he was always a highly principled person and very familiar with real estate cycles. He was one of the few real estate people in Denver that paid every lender as agreed, never had a default and didn't go bankrupt like so many other real estate developers, despite that market's deep cycles. Those are the values that he taught me growing up — we treat every dollar like it's our own. My father passed away in 2005, and my mother asked us to take over the management of the portfolio that he built for the family. Ultimately, the family made the decision to exit the business, and we completed the sale in 2012.

Your father never sold an asset, and now you've moved over to a more active style. What prompted that shift in strategy?

Zeff: We decided we could do this for others, and my dad didn't want to do that. When you have capital partners, you have to be respectful of that capital and their goals. Where we can add the most value is through our value creation, as well as our understanding of the markets and real estate cycles. Capital partners invest with us first to create value and then distribute the realized value back to them so they can reinvest it, hopefully with us in our next value creation vehicle.

You've just raised your fifth fund. How much of the capital in the early funds has been realized and returned to investors?

Beda: Our first fund was formed in November 2003. The fund was invested primarily in 2004 and 2005. Before the cycle crashed in 2008, we had sold about 40 percent of our assets, returning 100 percent of investors' capital, while still owning 60 percent of our assets, many of which were still in their value creation phases and on their way toward stabilization. When the recession hit, that would have been absolutely the wrong time to sell, and fortunately we had set up our financing so that we were able to ride through the cycle and come out on the other side. We are now in full disposition mode, and we expect to exit 100 percent of Fund I by early next year. Fund II was formed in 2005, and most of its acquisitions were at the peak of the market in 2006 and 2007. We got hit right in the face on the recession shortly after we invested most of that fund, and fortunately through thoughtful financings we were able to ride the cycle on that fund without any defaults and without handing back any properties. Even though Fund II was invested at the top of the market, the portfolio has a positive value now. We

CORPORATE OVERVIEW

Carmel Partners is a sector-specialist in real estate investment management, focused exclusively on U.S. multifamily investment strategies executed through its vertically integrated platform. Carmel believes the firm's investment specialization and platform produce a sustainable competitive edge in its pursuit of superior returns across market cycles. Founded in 1996, Carmel has attracted over $3.3 billion in aggregate capital allocations for its commingled funds and customized investment vehicles from many of the nation's leading institutional and private investors.

are in disposition mode for that fund as well.

How do you go about adding value? What do you do that is different from other firms?

Campbell: We identify properties that are underperforming their potential, and that underperformance can come from poor management, poor positioning within the market or obsolescence, where the amenities and the units and the property itself are not positioned to attract the strongest rents that could be achieved in that market or that location. We look for properties where there is upside potential, and we develop business plans through the due diligence/acquisition/underwriting period with the objective to bring the property from its current position to a position where performance can be maximized. There isn't any one single component that drives success. Good management alone can't maximize the value of a property. Making unit upgrades alone can't maximize the value of property. Improving the property amenities alone can't maximize the value of the property. It takes a concerted effort across all different aspects — management, marketing, renovation and amenity upgrades to fully transform an asset. We look at a project as a whole, and our value-add process addresses all of the components of a property's physical positioning and the management of that property in our effort to maximize the potential value of that asset.

There's a debate in the industry: Should we be investing with allocators, or should we be investing with operators?

Zeff: One reason people invest with us is because they don't like paying double fees and double promotes to allocators. Of course, when investors go with operators, they are concerned about whether the operator is going to be like your typical merchant builder, investing in every deal and not acting as a fiduciary. But we have demonstrated our ability to act in the best interest of our investors. The other benefit is our singular focus. Most allocators invest in every property sector, so even though they say they are going to look for the best risk-adjusted returns, investors may end up in some assets that may not necessarily be best in class because the allocator wanted a diversified portfolio of assets. An investor with the ability to invest in operators can build that diversification across property sectors without going to an allocator. The U.S. multifamily business is so very complicated. To find the best deals takes a lot of local knowledge and local expertise. We understand the multifamily business very thoroughly, and we think it's very complicated. We don't believe you can be an expert in all the sectors, and so it's our singular focus combined with both our execution capabilities and our investment management expertise that really separates us from other groups.

Dennis Markus: The Carmel Partners story is clear. We are owners, operators, developers and managers within the multifamily space. Our experience is specific, detailed and deep as it relates to the multifamily sector of the U.S. real estate market.

What would you say are the risks that you're facing in the apartment sector, and how are you addressing those risks?

Beda: Multifamily has a variety of unique risks, starting with the actual market where a property is located. What are the economic drivers? What are the key employment industries or sectors that influence the demand side of that given market? What is the risk to new supply? Is someone building a new apartment across the street? How available are other types of housing? For example, at certain periods of time over the past 20 years, affordable single-family housing was a threat to multifamily. Today that is less of a risk because of tighter credit standards for single-family buyers, particularly in the high-barrier markets.

Zeff: We think multifamily investment is a compelling story in the United States because we're the only western developed country with significant household formations. And so betting on U.S. multifamily or U.S. housing has generally been a pretty good bet.

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Campbell: Owning an apartment building is a book of consumer credit. You may have 200 households that make up a single asset, and they're deriving their income from a variety of different industries that are in a particular market.

How do you manage risk?

Beda: The first thing we do to mitigate risk is select markets that we think will outperform the U.S. multifamily market, and we believe those markets are the supply-constrained markets. We focus on markets with supply constraints and high home prices; that is reflective of limited supply, but we think it also means the buy-versus-rent equation is superior to the commodity apartment markets. Then within those supply-constrained markets we look for the best submarkets. Then within those submarkets, we select what we believe are the most superior locations. We try to put ourselves in the mind of the prospective residents. Most think about public transportation or where they will shop, so we visit the supermarkets near our properties and get a feel for them. We look at the units and we think about it like a resident. Where does the TV go, and where is my couch going to go? What's the closet space like, and where's my bed going to go? That really comes out of our development background. Our approach to development allows us to focus on what people want today, and we believe that gives us a competitive advantage to deliver a superior development product. On the renovation side, we won't be able to get exactly what a brand-new product would have, but we'll understand the differences and what compromises we're taking and how that translates to price. When we get a deal under contract, the people who are going to be executing that project are also responsible for the underwriting, and they have to sign off on the project. One of the things we believe that makes Carmel unique is we do not manage for other people, we don't do construction for other people, we don't do development for other people. We only do it for our funds exclusively, and we don't have competing funds. As a result, all the oars are pulling in the same direction, and you get this real focus on accuracy and risk mitigation.

Strong capital flows are moving into the market, and some investors are worried *that the sweet spot for multifamily may have passed. How do you respond to that?*

Campbell: Based on our analysis, the demand drivers for multifamily are as strong as they've been over the past 20 years, and we think the outlook going forward is that operationally apartments should be very strong. We are still seeing very good, compelling opportunities. We have to work hard to find them, but they still exist.

Can you see a point in time when things really do get overheated to the point where you'd feel uncomfortable continuing to commit capital?

Zeff: We've been through that before, and the fact is that we haven't changed the way we underwrite transactions since we got in the business. With the criteria we give our acquisition folks, it's very challenging to get a deal over the goal line. That leads us to be disciplined when things start to get overheated. We've shown ourselves to be disciplined investors through our process, rather than just committing capital because we have it.

Campbell: We have demonstrated the ability to recognize where we are in a cycle and invest smartly as it relates to that point in the cycle, and move into other spaces when the time is not right to continue investing in one type. There was a period of time in 2005 and 2006 when condominium projects were an attractive source of return, and we operated in that space on a limited basis. We brought our disciplined underwriting; we brought an approach that recognized that there was value there. We did a few condominium projects that were successful, and then we moved on before the market turned.

Beda: Carmel has also proven we have the capabilities to tackle really complicated deals that a lot of other managers don't have the resources to tackle. The loan purchase we did to acquire the equity of the Rincon apartments here in San Francisco is a good example. It was not for the faint of heart and took a lot of energy and resources and commitment.

Tell us a little bit about the debt side of your business.

Quinn Barton: We are only looking at multifamily debt investments, and we are using our property and underwriting expertise to evaluate multifamily opportunities. The debt investment business is something that we started in 2009 on the heels of the financial crisis, and we look at it as a complementary business to our overall strategy. We didn't invest in distressed debt simply to play in it; it was with an eye toward properties that we would invest in without the debt. We've also done a number of Freddie Mac first-loss B-piece investments. We are able to isolate the weak links in a pool of loans and try to fix those upfront through careful negotiation and discussion with Freddie Mac. So in the end we have a pool of assets we are comfortable underwriting and owning at our debt basis. The idea is to use our multifamily expertise to invest in an instrument that we think offers an opportunistic return with limited risk.

Zeff: Of the first-loss B-piece debt deals we've done, we've already returned more than 100 percent of capital, while still owning the vast majority of the upside of these note purchases. Our investors have been pleased that we are using our multifamily expertise to access a new strategy and seek attractive risk-adjusted returns in multifamily debt investments.

Barton: Typically senior or investment-grade buyers want to know who's done the due diligence on the first-loss B-piece investment, and we have a lot of name recognition and respect as investors and owners of multifamily real estate. Investment-grade buyers know that we do our own internal due diligence versus subcontracting it out and that we have a vested interest and the ability to execute strategies if loans ever go sideways to maximize a recovery.

How have you been able to make that turn to take on a fiduciary mindset where you have to put the interest of your third-party tax-exempt institutional investors above your own interest?

Zeff: I don't think that's a turn that we had to make. That philosophy goes all the way back to how I was raised and where we come from as investors. We treat every dollar like it's our own, and we've always felt that way. What we've learned is that institutional investors want a lot of transparency and a lot of early and accurate information, and that's why we've invested heavily in our back office systems and investor reporting.

What's next for Carmel Partners?

Zeff: We are committed to enhancing all aspects of our business, including expanding our senior management team, to ensure Carmel continues to meet our investors objectives. For example, Mike recently joined us in the newly created position of president, which will allow me to remain focused on the strategic direction of the firm and our mission to deliver superior returns.

Michael LaHorge: Ron and I have known each other professionally for over 30 years, with our real estate careers spanning several market cycles. I have also worked with Carmel over the past year in the role of strategic advisor. Carmel has an outstanding record of success through a variety of market environments, and I am honored and excited to join such an exceptional company. ❖

IMPORTANT DISCLOSURES

This article is for informational purposes only and does not constitute any offer to sell securities or investment advisory services.

This article may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements.

Nothing in this article should be interpreted to state or imply that past performance is indicative of future results.