

Rockwood Capital

Recently, **Sheila Hopkins**, Managing Director – Europe and Infrastructure with Institutional Real Estate, Inc., spoke with **Peter Falco**, **Walter Schmidt**, **Peter Kaye** and **Tyson Skillings** of Rockwood Capital. The following is an excerpt of that conversation.

How did Rockwood begin, and how did you arrive to where you are now?

Peter Falco: As a real estate investment management firm formed in 1995, we have evolved over the past 20 years. When Rockwood was first formed, we invested on behalf of several very significant high-net-worth families. Rockwood was fundamentally a full-service, hands-on investment firm created on behalf of these family offices that had decided to form a club to invest in the recovery of the 1990s real estate cycle. The management team joined together in 1995 to form Rockwood Capital and continued to invest on behalf of those families with a second fund. As the families started to liquidate their holdings in the later part of the 1990s and early 2000s, we were able to offer our services to the institutional market through a series of value-add commingled funds, beginning in 1998.

Walter Schmidt: From there we have been growing our investor base of endowments and pension funds, and we now work with more than 80 different investors. We are currently investing our ninth commingled fund, so it has been quite an evolution. We work primarily in the value-add real



Peter Falco, based in New York, is a Senior Managing Partner and one of the founders of Rockwood. Mr. Falco has 37 years of experience in the real estate industry. Mr. Falco serves on various portfolio management and investment committees, as well as the firm's management committee and Rockwood's investor committee (as chairman). Mr. Falco previously served as the head of Rockwood's Capital Markets team and as Chief Operating Officer.



Walter Schmidt, based in New York, is a Senior Managing Partner and one of the founders of Rockwood. Mr. Schmidt has 30 years of experience in the real estate industry. Mr. Schmidt serves on various portfolio management and investment committees as well as the firm's management committee and on Rockwood's personnel, staffing and compensation committee (as chairman) and Rockwood's investor committee. Mr. Schmidt previously served as the firm's Chief Investment Officer and before that held several leadership positions in the acquisition, asset management and disposition functions.



Peter Kaye, based in San Francisco, is a Managing Partner of Rockwood and has 21 years of experience in the real estate industry. Mr. Kaye serves on various portfolio management and investment committees, as well as the firm's management committee, Rockwood's personnel, staffing and compensation committee and Rockwood's investor committee. Mr. Kaye is responsible for co-heading portfolio and asset management along with Mr. Skillings. Mr. Kaye is the Portfolio Manager of Funds V and VII and therefore has overall responsibility for the portfolio management initiatives with respect to such funds. In addition, Mr. Kaye has responsibility for the performance of Rockwood's separate account investments.



Tyson Skillings, based in Los Angeles, is a Managing Partner of Rockwood and has 19 years of experience in the real estate industry. Mr. Skillings serves on various portfolio management and investment committees, as well as the firm's management committee and the investment strategy and research committee. Mr. Skillings is responsible for co-heading portfolio and asset management along with Mr. Kaye. Mr. Skillings is the Portfolio Manager of Funds VI and VIII and IX and therefore has overall responsibility for the portfolio management initiatives with respect to such funds.

estate space of select U.S. markets. To enhance our investment capability we have developed expertise working in four product types — office, retail, residential and hotel.

How do you explain your particular investment strategy?

Falco: Rockwood cannot be all things to all people, so we have to focus on where we excel. Our original focus was creating value through hands-on work or repositioning an asset, and sometimes also new development, and we have always specialized in mixed-use projects. We believe there are synergies between different uses. We continue to invest heavily in mixed-use areas, particularly in gateway, urban cores. We have watched the demographic and socioeconomic trend toward urbanization over the past 10 years, and we see that trend continuing into the future. Our expertise in each product type is very deep, and we think we bring a unique combination of skills to investing within the United States.

Peter Kaye: We also invest in select target markets. We see value in different product types in these target markets and have the flexibility and capability to successfully invest in different land uses within those markets. We diligently select markets based on unique demand drivers relative to other markets. We have consistently invested in our major gateway markets throughout the cycles as we try to select locations that either have solid demand/supply characteristics, or are emerging employment and population nodes. Our multi-product expertise affords us the flexibility to invest in different product types within those locations.

And why do you see value-added as a good spot on the risk profile?

Schmidt: Originally, we defined what we do as value creation, and through the years the investment community and particularly the consultant community has put categories around what different people do — core, core-plus, value-add, opportunistic. We have always looked across the risk spectrum at any particular time, depending on where we are in the real estate cycle. During 2001 and 2002 we did virtually no development. Instead, we invested in existing product because we

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thought that was the right point in the risk/return cycle. Coming out of this recent recession, we have invested in a mix of distressed assets but also early-stage development in some major cities with a plan to deliver into a recovering market. Real estate operates under a very long timeframe to execute business plans, and we try to look forward, evaluating not only what the current market is, but what the market will be two to three years out, and assess the risk.

Tyson Skillings: The U.S. real estate market continues to improve, but we find continued dislocation on the value-add side, especially in and around urban locations. We identify opportunities at the edges of urban nodes where we can create or renovate, redevelop, and attract new tenants to a project that caters to the needs and the experience that the end user is pursuing. We think there is a

particular opportunity right now to renovate and reposition properties into core assets, and then sell to core investors.

How many funds have you launched?

Falco: We are currently investing our ninth value-add fund and approaching our 20th year in business. Of our previous funds, Funds I through IV are completed. Fund V actually has one asset remaining, which is currently on the market. Those funds were invested and their business plans executed through all parts of the real estate cycle, so Fund III experienced the tech downturn in 2001, and Fund IV a recovery and Fund V a little bit of both. Funds VI, VII and VIII are each part way through their lifecycle. We instituted a disciplined Portfolio Management approach to create and manage our funds, and we think that discipline is paying off. Funds VIII and IX, which are managed by Tyson, are our most diversified, and yet maintain a strict adherence to our game plan in terms of product mix and risk.

You mentioned investing in gateway cities, major cities in the United States. With the recovery in the U.S., are you also beginning to look at secondary areas?

Kaye: We are certainly starting to see opportunities arise in some of the secondary cities. However, we have historically invested close to 70 percent of our funds in our gateway cities and remain focused on sticking to initial fund allocation targets rather than attempting to chase yield in markets in which we historically have not invested. Clearly pricing has gotten a little bit higher in the gateway markets, but we continue to find opportunities. In our view, the gateway cities are deeper from a capital market standpoint, and,

frankly, they performed best coming out of the downturn and we believe they will continue to outperform over the long term. We define risk by market and asset, and we purposely take risk when appropriate; however, we will not take both asset and market risk in one investment. We either take on more asset risk in a deep core market or far less asset risk if we choose to invest in a secondary market.

Falco: I would add to Pete's comments that it also depends on the diversity and durability of the economy of the particular market around which you are building your real estate value. We focus on two components very carefully to evaluate an opportunity. First, at the project level, it needs to be possible to meaningfully increase the stable cash flow of the asset, so that upon sale we can obtain credit for enhancing the long-term durability of the income of the asset. Secondly, we need to examine how the capital markets value that income. Gateway markets have the benefit of very strong capital market support. When you can combine an increase in durable cash flow with a strong capital market that highly values cash flow and will pay a higher multiple, there is the opportunity to create significant value growth.

When we purchase assets in secondary markets, we look for those with more durable income, and our hold periods in those markets are shorter because we want to navigate the more cyclical capital market support that those markets receive.

How do you stay disciplined and guard against style drift?

Schmidt: We studied that very carefully in 2008 and 2009, and we made a structural change in our company to establish a strong portfolio management function. As senior managers and partners, Tyson and Peter Kaye were given that responsibility. Structurally, we made the decision that we will manage our funds on a portfolio basis, and the assets had to be chosen, executed and disposed of according to that portfolio's strategy.

Skillings: Over the past five or six years, we have put a tremendous amount of effort and time into the evolution of a true portfolio management construct within the firm, and that dovetailed with the investment strategy that we have been talking about. At the portfolio management level, we have people responsible for each of our funds who are focused on balancing risk and creating

a diversified portfolio, such that each investment fulfills a specific role in the overall portfolio. A value-add opportunity may be a great opportunity, but it may not be the right opportunity for the fund overall. One thing we are very focused on is "speed to income" — determining how quickly value can be created at the asset level and new income put in place.

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How do you set up your investment team to handle this?

Kaye: About six years ago, we set up separate acquisition teams and asset management teams to deal with the downturn, but also to invest our Fund VIII and now our Fund IX. We have a dedicated acquisition team headed by senior partner Bob Gray and a team working with him that is exclusively focused on acquisitions. That team is supported by four very senior product specialists in hotel, office, retail and residential. Once a market with dynamic trends has been identified, we then have the ability to evaluate multiple product types within that market. That gives the acquisition team a level of support and expertise that allows a very in-depth, detailed review of each asset.

Skillings: In addition to the acquisitions and asset management team expertise, Rockwood has a capital markets team that helps the real estate underwriters and the asset managers properly

CORPORATE OVERVIEW

Rockwood Capital, LLC is a real estate investment firm that provides equity capital combined with real estate expertise for repositioning, recapitalization, development and redevelopment of retail, hotel, residential, office and research and development space in key markets throughout the United States. Since 1990, Rockwood and its principals have invested on behalf of their clients approximately \$16.8 billion of real estate through nine value-add vehicles and four separate accounts. Today, Rockwood is an 84-person real estate investment firm with offices in New York, NY; San Francisco, CA; Los Angeles, CA; and Seoul, Korea and manages a portfolio of approximately \$3.0 billion of net equity value in approximately \$7.9 billion of gross real estate value. Rockwood's investors include public and private pension funds, endowments, foundations, insurance companies, funds of funds, high-net-worth individuals and family offices.

capitalize those transactions; an in-house legal team that helps with the structuring and negotiation of tight joint venture and legal documents; and a tax, accounting/control and reporting team. When you put those teams together — acquisitions, asset management, capital markets, legal, accounting/control, tax and reporting — we have great synergies and an interdisciplinary ability to execute.

Schmidt: I recently heard it said that the real estate industry as a whole has not developed a very deep corporate finance function, that fundamentally the real estate industry likes real estate projects, real estate development, real estate operations, and that the industry's corporate finance skills are not as honed as they could be. Frankly, that is one place where Rockwood has spent a lot of time carefully developing the financing and the capitalization of our projects.

What lessons have you learned through the past cycle? And what challenges face you in doing value-added in a cyclical business such as real estate?

Falco: Rockwood is focused on understanding and protecting against downside risk — we are selective in making investment decisions. We are also focused on the feasibility of business plan execution. As a result, our investment horizons have become shorter in duration. Our bias now, based on the cyclical nature of the business, is that it is better to harvest our gains as early as you possibly can and move on and prepare our next strategy.

Schmidt: One of the things we have learned is that the elements that create the next downturn are never the same as the previous downturn. For example, the

industry had learned from earlier cycles that one of the enemies of real estate is the supply side and so became very focused on ensuring that real estate products were not becoming overbuilt and oversupplied. Well, what the industry collectively did not realize was that the economic downturn globally — triggered by problems in the capital markets — would so negatively impact the demand side. The demand implosion created a pseudo-oversupply and increase in vacancy. Even in the

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multifamily sector there was value diminution because of the demand impact. The defensive risk mitigation mode that we have come to is an income-based backstop to what we are doing. We need an income base in all our funds. The type of income — credit and stable — is a very important measurement for us because it provides a shock absorber even in times of recession and financial crises.

What is Rockwood's succession plan? How do you give the market comfort that the firm is going to continue for another 20 years?

Falco: Throughout our history we have maintained our company as a partner-owned entity. We have a long track record of succession and building a deep management team behind our strategies on behalf of our clients. One of the challenges of the real estate investment management business is building and retaining a great team over an extended investment

horizon, despite functioning in a cyclical environment. Two of Rockwood's founding partners have retired — Neil Smith in 2006 and Ed Kavounas just this year — but we think our team is stronger than ever. All told we have over 80 people within our organization, and we have concentrated on maintaining our hands-on real estate expertise, while also building a new level of portfolio and investment management discipline into our organization. Walter and I have been intent on carrying that through and building up the organization, and in bringing Peter Kaye and Tyson Skillings into the management of the firm, we are very confident we have an organization that will be making good real estate investment decisions in the many years to come.

How is Rockwood different from other real estate managers?

Schmidt: First, we believe we have one of the deepest, most experienced teams in the business. We are seasoned through cycles and have been working with each other for decades, so there is continuity in our business. Second, we follow a disciplined real estate investment strategy that focuses on value-add opportunities in the evolving urban nodes of our gateway markets. This allows us to create value at the asset level and leverage our team's expertise in office, retail, hotel and residential product. ❖

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