THE INSTITUTIONAL REAL ESTATE LETTER—ASIA PACIFIC

Sponsor Interview

Rockwood Capital, LLC

*Recently, **Alex Eidlin,** managing director – Asia Pacific and associate publisher of* The Institutional Real Estate Letter – Asia Pacific, *spoke with **Ed Kavounas, Bob Gray** and **Walter Schmidt** of Rockwood Capital. The following is an excerpt of that conversation.*

Can you give us an overview of Rockwood Capital?

Ed Kavounas: Rockwood Capital is a real estate investment company with about $6 billion of assets under management. We have a team of 10 partners, and we have 33 real estate professionals and 38 support staff in three offices in San Francisco, New York and Los Angeles. We have been investing together as Rockwood Capital and its immediate predecessor since about 1990. We worked through the Resolution Trust Co. crisis of the early 1990s, the downturn in the tech markets in the early 2000s and then the downturn in the past several years. We've made a total of about $12 billion in investments through that whole period of time. Rockwood is wholly-owned by its partners.

Bob Gray: Before our first value-added fund in the early 1990s, we had separate account investments with some high-net-worth families. At present, we have commingled funds and separate accounts. Core investors in particular have demonstrated some preference toward separate account structures. So we invest both commingled funds and separate account capital. That capital is invested directly or through joint venture structures, and we also invest through debt structures, primarily mezzanine or first mortgages, as an equity alternative or simply as what we determine to be a good investment on a risk-adjusted basis. So, we're active up and down the capital stack.

What has Rockwood achieved during the past 23 years?

Kavounas: Each of us and most of our colleagues have had the opportunity to personally execute every aspect of the real estate business. We have built buildings, we have entitled property, we have leased space, we have financed properties, and we have worked out properties. We have been involved in every aspect on the ground, so we understand the forces that make a project successful.

Walter Schmidt: Rockwood Capital is a real estate investor. We've had many opportunities to become a real estate service provider, to be fully integrated into the development process, into leasing and sales and all kinds of service opportunities, but we declined them. Rockwood Capital is all about real estate investment, and we wanted to stay on that side of the business. We invest our own capital alongside our institutional investors' capital, and then we work with outside professionals for the services part of our business. Our primary responsibility is to our investors, and our investors rely on us because we are significantly aligned with them.

Why don't we talk now about products and strategies. What product types do you invest in?

Gray: Rockwood invests primarily in office, residential, retail and hotel product. Our history is quite deep in office, with a particular focus on the deep core markets and specifically New York City, San Francisco/Silicon Valley, Boston's Cambridge area and Washington, D.C. We are focused on those markets that have a high level of supply constraint, as well as what we refer to as knowledge-based employment growth, which is largely technology-driven.

Kavounas: Over the years, we have been focused on brains and education, and on global cities. We are advocates of clustering. For example, we have invested in millions of square feet in San Francisco and the Silicon Valley, where Stanford University is a hub for technology businesses throughout the region. We've been focused on the technology markets in Northern California and have taken advantage of them by developing and buying office and other product types in the Bay Area.

What investment strategies has Rockwood been pursuing over the years?

Gray: Our basic value-added strategy is to take an asset with risk, then strive to de-risk the asset and put it into a position where we can harvest gains. With respect to our value-add strategy, we think there's a great opportunity to buy assets that have some element of risk — whether it be re-leasing, renovation, repositioning — and seek to de-risk them through renovation or lease-up to move them into a core profile, at which time we would either sell or refinance to capture increased value. We tend to take more product risk in the deep core markets, and we'll take less product risk in the

CORPORATE OVERVIEW

Rockwood Capital, LLC is a real estate investment firm with offices in San Francisco, Los Angeles and White Plains, N.Y. Rockwood Capital provides debt and equity capital for core, core-plus, value-add and special situation real estate investment opportunities. Rockwood Capital manages more than $6.3 billion of real estate.

markets that are more volatile, such as Miami and Phoenix. With respect to our core strategy, we are biasing toward a core-plus orientation and taking a little bit of lease-up and/or lease rollover risk, which we believe is a prudent strategy in a recovering economy to seek higher yields.

Schmidt: One of the overriding investment strategies that we have is that we believe in the power of mixed-use, whether we create the mixed-use in our own project or whether our project is in a mixed-use environment. We think people increasingly want access to work/play lifestyle environments, and over the long term those will be the higher value centres.

The past four years have been very difficult for investors and asset managers alike. How did you manage assets and invest during the years from 2008 through the downturn?

Kavounas: We realised we were going to be going into a major financial crisis in 2008, and we increased the expertise and size of our team in order to be able to manage assets that in a more normal market we would have either developed or added value and then sold. For example, we had to restructure debt, we had to restructure leases, and we had to restructure ownerships with development partners. We took a very active role in working through multiple asset issues. This took a very dedicated team, and we now have a team that has been battle-hardened through the years, which I think has made us a much stronger company.

Many asset managers lost their mandates during this recent downturn. How did Rockwood work with its investors?

Schmidt: What was paramount to investors was a tremendous amount of transparency and focus. Being investors ourselves, we had to come to terms with our position in the recession. We did mark our funds to market very aggressively during the downturn, and our investors were very appreciative of that transparency. We told them what was going right, and we told them what was going wrong, and we explained to them on periodic calls during the years what we were doing about it. We also were very frank with our investors on which particular projects we were no longer going to invest in, and we made some tough decisions, but all with transparency with our investors.

Where do you see opportunities today and over the next two to three years?

Gray: Fundamentally, real estate is a cyclical asset class with windows of opportunity to buy and sell. Navigating these cycles within the confines of limited duration investment vehicles is a challenging endeavour. We really are focused on product cycles. On a going forward basis, we are buying assets that have some element of risk and seeking to de-risk them. Rockwood has also been a very active seller the past couple of years in order to harvest gains in a market that is starved for investments with a current yield.

Currently, we're pursuing investments in the hotel sector not just because the hotel sector is recovering, but also because capital market conditions remain stringent for hotels, thereby resulting in what we believe to be an attractive

Edmond Kavounas, based in San Francisco, is chairman and one of the founders of Rockwood. He has 42 years of experience in the real estate industry and serves on all of Rockwood's investment committees, Rockwood's investment strategy and research committee and Rockwood's new business and investor strategy committee. Mr. Kavounas was president and CEO of Rockwood from its inception in 1995 until 2010. As the firm's chairman, Mr. Kavounas now works with Rockwood's co-managing partners and the other principals to guide the execution of Rockwood's real estate and corporate strategy.

Walter Schmidt, based in White Plains, N.Y., is a co-managing partner and one of the founders of Rockwood. Mr. Schmidt has 28 years of experience in the real estate industry. He serves on various investment committees as well as on Rockwood's investment strategy and research committee and personnel, staffing and compensation committee (as chairman). Mr. Schmidt previously served as the firm's CIO and before that held several leadership positions in the acquisition, asset management and disposition functions.

Robert Gray Jr., based in San Francisco, is a partner and one of the founders of Rockwood. Mr. Gray has 26 years of experience in the real estate industry. He serves on various investment committees as well as on Rockwood's investment strategy and research committee (as chairman) and personnel, staffing and compensation committee. Mr. Gray has overall responsibility for managing Rockwood's acquisition activities, including personnel located in the firm's three offices. His specific responsibilities include overseeing the selection of markets, projects and partners, and the negotiation and structuring of transactions. In addition, he plays a key role in the development of the firm's real estate investment strategy.

equity opportunity. We like office product in the deep knowledge-based markets. And, consistent with our value-added strategy, we're going to continually take some element of risk — it might be a redevelopment, it might be vacancy, it might be some form of renovation. A lot of development and redevelopment projects are in need of stronger sponsorship and capitalisation, and we believe this is creating an attractive equity opportunity, as the gap between unstabilised properties and stabilised properties is as wide as we've seen it.

Where do you see the real estate markets and the economy in general in the United States during the next two to three years?

Schmidt: It's a fascinating time in the investment cycle because the capital markets are looking backward to some extent. Many people consider 2007 to be a peak, and obviously 2007 was a value high in many product sectors in a lot of markets. But we are not comparing performance between now and a market peak. We don't look at it that way. We ask, what is the fundamental growth in income and valuations of a particular product/market? Certain markets have already exceeded 2007 performance on an operating income basis, and some have even gone past the 2007 valuation levels. If you have a mixed-use asset that you can either develop or redevelop in a faster-growing market such as South Midtown Manhattan or San Francisco or Boston, we believe there is potential to create some very significant real estate profit margins.

Kavounas: One thing that will be very interesting to see is how the United States works its way through the current budget and fiscal issues. One city that we've invested in for years is Washington, D.C., and the prognosis for Washington in the shorter term has to be that there will be cutbacks on the office side and even on the hospitality side. That's a market that we would like to watch and wait, and maybe over the next couple of years we'll see opportunities develop. We're trying to go to places where there is great long-term mixed-use potential, and all of the cities that we have been talking about fall in that category.

Ed, you've mentioned that the US economy is very resilient and different from other economies specifically because we have low cost of capital and competitively low fuel costs, and because of that US markets may be attractive to overseas institutional investors. To your mind, have those factors changed, or does the United States still benefit from low cost of capital and competitively low energy costs?

Kavounas: In my trips to Asia, I have found that there is a comfort factor on the part of large Asian investors with investment in the United States. First, I think there's a general belief that while worldwide growth is going to be slower than it has been, the US is going to be pretty steady. We believe it's a safe place to be. And on a risk/reward basis, if you compare the returns, particularly core returns, from US real estate compared with Treasuries or other high-quality debt instruments around the world, the returns that US real estate offers long-term core investors still remain very attractive. Over the next five to 10 years the United States has an opportunity to be, even though growing at a slower rate, a place where there will be increasingly more attractive growth compared with the rest of the world. We have a favourable energy outlook here in the United States, and we have a generation — the Gen Y group — of about 70 million people who are rather well educated, more than 50 percent of them have advanced degrees, and we are attracting from all over the world very capable young people to our universities. If US immigration policy becomes more attractive, this will increase the workforce that makes this country strong, and I think that will continue to make the United States an attractive place to be for the next five to 10 years.

Rockwood Capital is quite skilled in value-add strategies, but are there any other strategies that Rockwood has pursued in the past?

Kavounas: Over the past several years we've done two things that were a little bit out of the box. In 2000, we leased a building to a data centre development company that went bankrupt. We took back the data centre and set up a company to operate it, and then bought four more data centres. We built up that income and then turned around and sold it to Digital Realty Trust. More recently, during the downturn, we invested in an apartment developer with a national footprint. So those are two businesses that were a little bit different than what we had done before.

In addition, over the years, we've evolved into having more focus on hospitality and retail, looking at places where we thought that hospitality and retail would be attractive investments on a very focused basis. Lastly, we have opportunistically invested in subordinated debt positions across various asset classes.

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Gray: The reason we invested in an apartment entity was not just attributable to the favourable outlook for apartments in 2010, but also because we believed tight credit conditions created an attractive equity investment opportunity. Coming out of the downturn in 2009/2010, many private development companies were short on investment capital, short on liquidity and net worth, at exactly the same time that the lenders were increasing liquidity and net worth requirements in connection with obtaining construction loans. So you had these essentially opposing forces of improving fundamentals and tightening credit that created a massive equity need in the apartment industry. A lot of apartment REITs are developing properties because they have the balance sheets to be able to finance that development; however, private developers are finding it challenging to capitalise projects, particularly as it relates to obtaining debt financing. We looked at the environment in 2010 and saw the opportunity, and that was the primary reason we got involved in the apartment sector in a more major way through an entity transaction.

What do you think are Rockwood's competitive advantages compared with other real estate investment managers?

Schmidt: The stability, strength and depth of our team is our biggest competitive advantage, and we believe Rockwood has one of the deepest partnership teams and management teams in the business. We have 10 owners/partners active in the business. We have a clear succession plan that doesn't rely on any one individual. And below the partnership we have a senior management team of very experienced professionals. We also believe that another competitive advantage is that we have made a very clear choice to be a multi-product investor in the markets we select. We believe that both of these elements add to Rockwood's credibility in the marketplace.

Kavounas: One more thing is that Rockwood has a mix of experience with teams that have worked together for a long time. For example, Bob and Walter and I have been working together since 1990, and Walter and I since even before that, and we're not the only ones. And there's also a group who are younger but have been with us for a long time also, and then there's a newer group that's come in, so we have the mix of experience and talent and energy that make Rockwood a very effective group as a whole.

> *"We come from a real estate background. All of us have had substantial real estate experience, and that allows us to really understand how the markets and product types work and how the cycles can work. We have a saying around Rockwood that we borrowed from a legendary ice hockey player: 'Let's skate to where the puck is going to be, not where it has been'."*

What would you like Rockwood to be known for?

Gray: Walter hit it on the head when he said that "Rockwood is a real estate investor." We come from a real estate background. All of us have had substantial real estate experience, and that allows us to really understand how the markets and product types work and how the cycles can work. We have a saying around Rockwood that we borrowed from a legendary ice hockey player: "Let's skate to where the puck is going to be, not where it has been". We want to be in the Meatpacking District in New York City before it's the hot place to be, or we want to be in South of Market in San Francisco before everybody discovers it, and the only way to do that, frankly, is to spend time in the market as an investor and owner. You cannot helicopter in and think you know the market; you must have boots on the ground. ❖

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