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Navigating a Hot Real Estate Market

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We are living in an extremely interesting time in the real estate business, which is absolutely on fire in many categories. Today's real estate investors are looking for ways to narrow the gate and continue to make money in a marketplace where prices and values are rapidly escalating combined with unprecedented liquidities. However, experienced real estate veterans know the three factors of price, liquidity and risk go up together, and they go down together. Understanding the cycles is an essential tool for time-honored value investing.

Sound real estate investment involves investing through a cycle. There are opportunities to make money in all phases of the cycle, however it is critical to:

1. Analyze what the future holds and not what has happened in the recent past.
2. Abstain from herd mentality and from anything extreme.
3. Focus on fewer but higher margin opportunities.
4. Invest with specialists who understand their niche (e.g. who do the same thing over and over and who have experience).

In other words, stick to the fundamentals. Understand and work the cycles rather than react to unabated trends, and recognize the difference between histories, cycles and value orientation vs. momentum investing. Real estate is a phenomenal business, an entrepreneurial business, but it is a *long-term* business.

Case Studies

What follows are two examples of how we use these and other time-tested principles of value investing. One involves a major redevelopment in Stamford, Ct., and the other is a retail strategy where we buy out distressed retailers to access and recycle their real estate.

Let's start with some of our general principles:

1. Only buy from sellers who are not in the real estate business, such as municipalities, estates, bankruptcy trustees, passive landowners, etc.
2. Focus on high barrier markets where there are real constraints on competition.
3. Create income through change of use. Look at everything not as it is now, but as it will be in two to three years.

4. Execute through local operating partners – experts who are insiders to their markets.
5. Establish a competitive cost advantage.
6. Pursue risk-mitigating strategies, such as presale, phases, refinancing your capital back, always trying to take some money off the table.
7. Achieve dual liquidity options through refinance markets, lot sales, etc.

These seven points are at the foundation of how we created property values through unique land assembly and adaptive reuse of existing structures in Stamford and how we were able to unlock values of property acquired from distressed but asset-rich retailers.

Stamford CT Redevelopment

Our redevelopment of the Stamford, Connecticut waterfront is an example of the use of four strategies in one asset: Brownfield redevelopment (e.g., cleaning up environmentally contaminated sites); adaptive reuse of older buildings in a high-income area (renovated as apartments); the use of "pre-leasing" as a way to start an office development; and the use of the "stacked retail" concept.

It's also important to note that the Stamford project had four considerable upsides going into this project. It is right on the water; it's surrounded by an affluent community in Greenwich; it had existing transportation infrastructure; and the largest trading floor in the world was under construction – across the street.

The four properties we worked with were individually owned industrial parcels with very little value on their own. Individual lots were surrounded by equally unattractive and polluted acreage. When assembled, however, they comprised 80 acres on the waterfront.

The assemblage had two main goals: to transform dormant industrial property into a valuable master planned community, and to establish a significant cost advantage in every facet of development over the next ten years. The principles of the master plan included taking advantage of transit; bringing Stamford to the water; creating a great public space network; creating new and exciting "destinations;" and creating distinctive neighborhoods.

Prior to redevelopment, people working in Stamford were cut off from the waterfront by the industrial structures. By creating park systems, bike paths and walkways we created a great public space network and a much more attractive environment. Each of the three main communities had a different strategy.

1. Yale and Towne was designed as a stacked retail and residential development. This included redevelopment of an historic building, which netted us a 20 percent tax credit and covered the bulk of our initial costs for the land acquisition.
2. Harbor Square, a center for restaurants right on the water, which was to include a new headquarters for Starwood and a 125-room St. Regis hotel.
3. Admiral's Wharf, a new residential community right on the water in which we created enormous animates: parks, spas, restaurants, etc. in the high-income area of Stamford, Ct. This also presented an opportunity to be creative in bringing down our cost basis. We created a performance bond by selling off 14 acres worth of 45-foot lots at $2 million per lot. This

created a significant cash flow that funded the retail developments at Yale and Towne, and put us in a good position of phasing the development and generating cash to fund ongoing development.

The Retail Marketplace

There has been a huge evolution in the retail marketplace in the last few years. Early on, there were only two asset types in the retail marketplace: shopping centers and strips. Then came malls and then, over time, department stores, and then the big box retailers started to enter the picture. The big box retailers have hit the department stores pretty hard – and a lot of things have happened as the big box industry has proliferated. For instance, Target is now a mall anchor, and a lot of mall-like tenants are going to the lifestyle centers that include residences.

The growth is in the big box retailers, but they want density, income, a lot of parking and they want critical mass. Best Buy doesn't want to be there alone; it wants to be with other retailers. To build the traditional power center (500,000 square feet of leasable area) requires 50 acres. In high density, high-income urban areas you never have that much to work with, but if you stack the three big box retailers, you achieve critical mass, direct parking and great visibility. And if you do it right, (i.e. pair with lifestyle centers and attractive architecture), the community will welcome it.

To get the property needed to attract the big boxes, we target distressed retailers with large property holdings in urban in-fill locations such as the old K-Marts, Service Merchandise, Montgomery Ward, etc., who owned or controlled great real estate but who weren't in business there any more. Acquiring operating retailers with real estate holdings creates several opportunities. It can provide the still-operating retailer with a cash influx to stay afloat, while putting the buyer in a position to do a leaseback and re-lease the closed locations. In the downside cases, the acquisition price covers the retailers going bust, and the buyers get all the dark space to re-lease and cover themselves. In the upside cases, buyers monetize the rent in capital markets and the EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization.) in the private equity market, which creates the ideal double valuation position. Additional opportunities in this type of acquisition include leasehold conversions, rent re-allocation, leveraging of redevelopment rights, and trading currency.

Real estate is one of few businesses that foster entrepreneurism, passion and creativity. It is still a business of entrepreneurs, supply and demand and value creation. Those who stick to the time honored fundamentals while ensuring they can cover their down side, will continue to find real estate a great business in which to participate.

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