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The next generation

After 25 years of investing in US real estate, the property arm of Investcorp is looking towards its next stage of growth. Here, John Fraser and Jonathan Dracos, the co-heads of the firm's real estate group, talk about opening a new office in Los Angeles, courting US investors and possibly expanding into Europe. [By Aaron Lovell](#)

Sitting in a conference room with some of the principals of Investcorp's real estate department, you quickly get the idea that they work well together. In addition to the fraternal joking and good humor between the group, including co-heads John Fraser and

Jonathan Dracos, and principals Peter Petron, Joel Moody and Herbert Myers, the firm's partners also have a long track record of working together—even before they began their careers at Investcorp.

"There's a common theme that runs through this place, which is that a big percentage of the group had knowledge of each other before coming here," Petron says, rattling off the myriad professional connections between various members of the firm. "Pretty much everybody has spent the majority, if not all, of their careers in real estate."

The real estate team is part of Bahrain-based investment house Investcorp, which has \$10 billion (€8 billion) in assets under management in the form of private equity, hedge funds, property and venture capital strategies. Even though property makes up a relatively small percentage of the firm's assets, Investcorp's first investment was actually in real estate: The company acquired a 50 percent stake in the ManuLife Plaza office building in Los Angeles in 1982.

But that was a long time ago. Following its initial property investment program, which ranged from 1982 and 1994, Investcorp looked to reestablish its property investment group in the mid-1990s by bringing in a new team to work through some of the troubled assets it had acquired earlier in the decade. Fraser and Dracos both joined the firm during that time, which was the beginning of what they consider to be the second generation of the real estate business.

With new blood, Investcorp built up its property investment capabilities and expanded the firm's real estate platform. Since 1995, the firm has acquired more than 200 properties and now has a portfolio valued at more than \$3.5 billion. For the quarter ending March 2007, the firm deployed \$157 million in equity in eight properties. For the fiscal year ending last June, it acquired 46 properties underwritten at \$321 million—and it plans to invest \$500 million annually going forward.

As the firm's real estate equity investment platform ramps up, Investcorp is now looking to add another chapter to the story. The firm is expanding its real estate product offering, opening an office in Los Angeles and considering expanding its geographic mandate to Europe.

Over the past decade, things at the team's parent company have evolved, as well. Though publicly trade private equity firms have recently come to prominence in the US, Investcorp was founded as a publicly traded company

in Bahrain in 1982. The firm listed its shares in London last December.

"The listing has had great benefits to Investcorp generally speaking in that it provides—certainly in the region where we raise a lot of capital—an ability for people to invest in the company, to share in its success, in addition to being investors in the transactions themselves," says Fraser. "Obviously, listing in an exchange like London brings some broader international exposure to the firm, as well as provides market liquidity, which is also a benefit."

Because of its status as an arm of a publicly listed entity, Investcorp's real estate division doesn't approach its investments in the traditional limited partner structure. Instead, the group makes its investments directly off the firm's own balance sheet, underwriting the equity portion of each transaction and then syndicating the deal out to its investors. According to the firm, it then keeps between 5 and 10 percent of the equity as a co-investment stake.

"We function as a true private equity shop that happens to be held in a quasi-public ownership structure," Fraser says.

Within that structure, the firm offers a number of real estate investment products, from a recently launched mezzanine debt vehicle to core-type deals to more opportunistic repositioning projects and development work. The firm estimates that approximately 60 percent of its projects in the past year would be considered core-plus, with the balance being more opportunistic.

And while the firm arranges its projects by sector type and geography, Fraser doesn't seem to pay much mind to labels. He says that everyone in the 15-person shop handles deals across the risk-return spectrum.

"We're buying real estate," he says. "If one happens to be a higher-risk/higher-return play, fine. If one happens to be a lower-risk/lower-return play, fine. We take those assets and marry them with the investors in our universe of investors."

The firm's investments span the US retail, office, residential, industrial and hotel sectors, but Fraser notes that the firm avoids large-scale corporate plays in favor of straightforward asset acquisition and development.



Fraser (L) and Dracos (R): sticks-and-bricks investors

“We’re first and foremost a sticks-and-bricks investor in real estate,” he says. “We have purchased some real estate operating companies. We have looked at a number of public-to-private transactions. The bulk of our business is buying sig-

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nificant control investments in property and land development projects, owning them for mid-term holding periods and generating expected returns out of that.”

As part of its effort to broaden its investment management business, the firm is now offering new ways to access the capital structure in real estate deals.

To this end, the firm recently teamed up with Connecticut-based investment and advisory firm TriLyn and the Bank of Scotland to launch TriLyn-Investcorp Mezzanine Partners, a

fund that makes mezzanine, high-yield debt and preferred equity investments in commercial and residential real estate in the US, including acquisitions, development projects and land investment. The \$100 million fund launched last October, though

Investcorp says the fund’s size has since been increased to \$120 million.

“We want to maximize the productivity of that machinery,” Fraser says. “In addition,

from a capital standpoint, we’d like to be intelligent real estate capital providers in the market.”

Investing broadly

Investcorp has a broad mandate, which allows the firm to pursue a broad range of transactions, from retail malls in Cincinnati to residential projects in New Jersey and Brooklyn. In Miami, for example, the firm recently acquired a particularly



Dracos: time for change

well-located Holiday Inn in South Beach, which it razed to develop a W-branded hotel and condominium project. Despite the ups and downs in the South Beach market, the condos have still sold well, according to the firm.

“Because of the quality project, because of the location, because of the brand, because of the flag, because of some of

“We want to be that much closer to the transactions and, frankly, the operating partners, too. You can go out to dinner with them and continue to develop those relationships—that’s harder to do from 3,000 miles away.”

the other amenities we’re looking to include in the project, the sales have been unbelievably strong,” Myers says. “While costs have gone up on the construction side, sell-out pricing has far surpassed the underwriting.”

Across the country in San Francisco, the firm acquired a historic Bank of America building on Powell Street in 2003. Myers says the bank has moved into a retail outlet on the first floor, while the former grand banking hall has been converted into a Forever 21 store. The upper floors have been redeveloped into luxury apartments.

The firm has done a number of large transactions in 2007 as well. In May, the firm acquired a portfolio of nine geographically diverse hotels from The Procaccianti Group in a deal val-

ued at \$450 million. Last month the firm was close to investing in another mixed-use project on the West Coast, which would represent the firm’s largest equity investment to date: \$200 million.

While around one-third of Investcorp’s deals are in the West and Southwest, the firm has always operated out of the office in New York. But, in another sign of change at the firm, Investcorp’s real estate team recently opened a new four-person office in Los Angeles, to be headed up by Joel Moody.

“We had a number of investments in the West over the years, but if you look at our activity over the past few years it’s been predominately in the Eastern half of the country,” Moody says. “As an effort to address that and balance things out, we thought the best way to do that was to put a team out in the West that would have closer proximity to the key markets and be able to build up relationships.”

Dracos says that the satellite office will look after opportunities west of Denver, but that the strategy across the US will remain the same and the personnel between offices will have a fluid interaction—professionals in California could come back to New York to assist with big deals and vice versa.

While Investcorp has not embraced the satellite office model in the past—the firm has a presence in New York and London, in addition to its headquarters in Manama, Bahrain—Dracos thinks it will be beneficial in the relationship-driven real estate business.

“We want to be that much closer to the transactions and, frankly, the operating partners, too,” he says. “You can go out to dinner with them and continue to develop those relationships—that’s harder to do from 3,000 miles away.”

The firm might start looking at investments even further away from its Park Avenue base. Dracos says the firm is evaluating a possible expansion of its real estate activity into Europe. The rest of Investcorp’s business lines are active on the continent, operating out of the London office, he says. Still, despite the active property markets in the Middle East and Investcorp’s presence in the region, the firm is not looking at investing in real estate in the Gulf region at the present time.

Middle Eastern money

Because the Investcorp investor base is made up almost entirely of residents of the Gulf Cooperation Council region,

some of the asset portfolios Investcorp assembles are sharia-compliant, meaning they follow the code set forth in Islamic law—certain properties, rent rolls and existing capital structures could all disqualify an asset from being compliant.

“When we can, we do [make sharia-compliant investments],” Fraser says. “Otherwise, we don’t.”

According to the firm, between 15 and 20 percent of the equity it deployed last year was in sharia-compliant assets. Though there is a tremendous demand for compliant property, Dracos says “we have much more demand than product.”

Fortunately for Investcorp, demand for US real estate continues to be strong among GCC investors as well. Boosted by huge increases in oil revenue, wealth from the region is now spilling over into the US property markets—as can be seen in the large property acquisitions being made by Middle Eastern-backed private equity and real estate firms.

But with institutional investors clamoring to get into private property investment vehicles around the world, Investcorp is now looking to open up its real estate platform to non-Middle Eastern investors for the first time. The group recently had its 12-year track record audited and it is going to discuss the proposal at its annual senior partner meeting in July.

“If we were to do it, the moment in time is a pretty good time to do it,” Dracos says. “We just had the track record finished. We just added some capacity like the West Coast office and beefing up the acquisition and asset management team over the course of the past two years. I think if we were to do it, we’d have to take the bid evaluation quite seriously in the next six months.”

Dracos says the firm has spoken with fundraising groups who have indicated that its platform would be attractive to Western institutional investors. He adds that the firm would pursue a more targeted fundraise if it decided to attract additional capital providers.

Natural tension

Discussing the current state of the US real estate market, the partners at Investcorp seemed to remain relatively optimistic. Though they admitted there was plenty of competition, they didn’t seem to be too concerned.

“I think that’s a good natural tension,” Dracos says. “Every year is a difficult time to buy.”

“Between the flexibility of capital and growing the team in the process, opportunities still continue to present themselves,” he adds. “Is it as easy to find opportunities as it was three years ago? Probably not.”

Still, as Investcorp approached the end of its fiscal year last month, the real estate team seemed to

be focused on the future: The office opening in Los Angeles, the decision to begin courting investors outside the Gulf region and even the possibility of expanding its property investment platform to Europe.

But the partners stressed that the firm is careful to make sure its growth occurs in a managed way. “We try to bite off the appropriate amount each fiscal year,” Fraser says.

The property arm at Investcorp has evolved from its initial acquisition period in the 1980s to a more sophisticated and tumultuous period of turnarounds in the mid-1990s to the current platform. Considering the changes the firm is going through now, Fraser says that the latest initiatives are the beginning of the third stage in the firm’s evolution.

“I think we’re probably on the doorstep of the next generation,” he says. □



Fraser: on the doorstep of the next generation

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