PrivcapRE/Presents

A Conversation With
Richard Mack
Mack Real Estate Group

With insights from:

Kirkland & Ellis LLP

Featured Charity:

Robin Hood Foundation

About Privcap Media

Privcap is a digital media company that produces events and digital thought-leadership content for the global private capital and private real estate markets. Privcap Media offers communications services to market participants.

Privcap is known for its authoritative online video programs and digital reports. Since its launch in September 2011, Privcap has produced dozens of focused reports, and about 800 video programs—mostly in-depth interviews and panel discussions with private investment experts. In the private equity and private real estate markets, Privcap's audience has grown to about 8,000 unique visitors each month—a mix of institutional limited partners, general partners, high-net-worth investors and service providers. Each week, Privcap and its sister site PrivcapRE release and promote new content.

Contact

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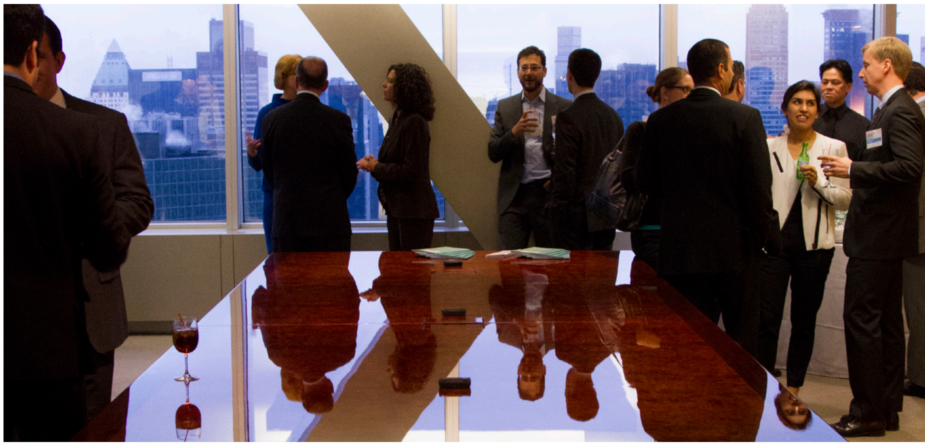
If you are a service provider interested in being a sponsor of a future event and report, please contact Gill Torren at gtorren@privcap.com



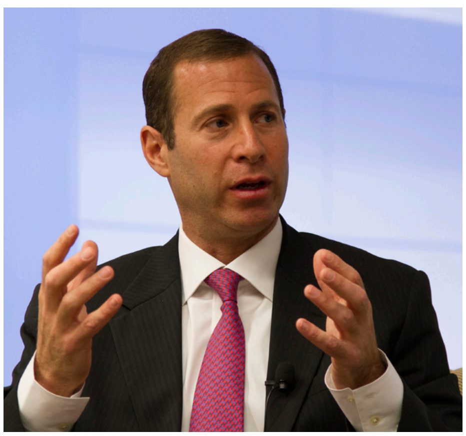
About PrivcapRE Presents

PrivcapRE Presents is a series of invitation-only networking events designed to bring together GPs, LPs and other guests. The events are organized by Privcap Media and hosted in partnership with leading professional service providers.

Each PrivcapRE Presents event begins with an intimate, on-stage interview with a notable leader from the private real estate industry. A transcript of that interview is used as the basis for a digital report (like the one you're reading now) that is made available to Privcap's global audience. Also included in PrivcapRE Presents reports are perspectives from the event partners, including a non-profit selected by the featured interviewee.

Investing For The Long-Term

At the PrivcapRE Presents event on March 31, PrivcapRE editor Zoe Hughes interviewed Richard Mack, co-founder of Mack Real Estate Group, on his long-term, multigenerational approach to wealth enhancement through multifamily development, the growth of financing strategies, and the next tipping point for commercial real estate.



Richard Mack, Mack Real Estate

PrivcapRE: You recently sold AREA Property Partners to Ares Management, yet one of the interesting things is that you retained several parts of that group. Can you give us a sense of how that is impacting your strategy and helping you get so much scale as Mack Real Estate?

Richard Mack, Mack Real Estate: We retained a property management business, and right now we manage about 9,000 multifamily units and about 9M square feet of commercial space. We also conduct asset management in the debt space for a public company. This gives us arms and legs all across the country that can process a lot of information, and that's very, very important for us to hold on to. We also retained a multifamily development business, and this is probably unusual for a private equity firm, but within AREA Property Partners before we sold we were building our own in-house multifamily development capability. We felt that multifamily was going to outperform. We were taking all the risk as the equity partner, so we decided we might as well own the capabilities.

What was the strategic investment rationale that you saw for keeping the multifamily development platform you put together at AREA?

During the Great Recession, we decided not to chase distress. And the reason was that the returns looked a little skinnier than they did last time, and the multiples certainly a lot skinnier. But yet we could do things like buy cash-flowing multifamily. We started buying them at 7.5 percent yields with 4.5 percent cost of financing. And we thought that was probably an unsustainable spread between interest rates and cap rates.

Where did that lead you?

We chased cap rates down. And you know, it didn't last at 7.5 percent, but interest rates and our cost of borrowing went down dramatically. We were buying in a weakening economy, or a flat economy, and yet occupancy kept going up. And rents kept going up, so we were looking at that and saying, "Well, there is maybe something to this… And when the economy actually starts to come back and we have household formation, maybe we should be in the development business. We want to be there early, not late." And that's how we somewhat stumbled into the multifamily development business in urban markets.

I think it's fair to say you did more than stumble into the business…

We have 5,000 units either built or under development. That's about $2.5B of construction, so it's not a bad place to be from a standing start.

You've moved rapidly into that space. But looking at multifamily now, why development and why not acquisition?

We don't have a predilection towards building things, so if we could buy, we would. But the assets that we are building to between 5.5 percent and 6.0 percent yields, we'd have to buy at 3.5 percent to 4.0 percent yields. And that spread, while it doesn't seem like a lot, is actually historically pretty wide. The difference between a 10 percent cap rate and an 8 percent cap rate is much

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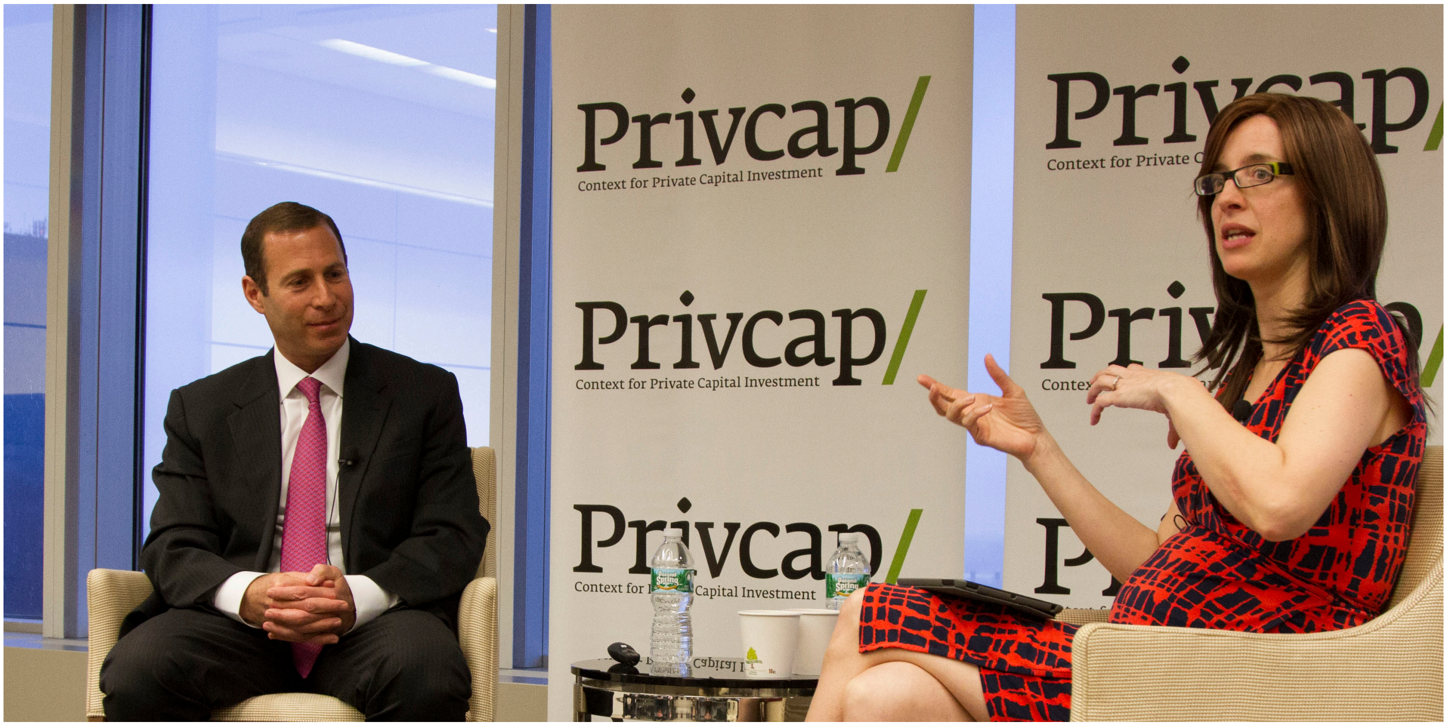

Zoe Hughes interviews Mack Real Estate's Richard Mack during the March 31 PrivcapRE Presents event

smaller than the difference between a 3.5 percent cap rate and a 5.5 percent cap rate. Our view is that we want to hold these assets. We are focused only on high-barrier-to-entry markets, which is why the cap rates are so low. And these [assets] are both high-growth and high-barrier-to-entry.

You mentioned that you want to be there early, not late. What are the implications of that in multifamily development?

We want to hold these assets. If you have a 20-year horizon, you've got to get the land cheap enough and early enough to be able to make rentals work. It's very, very hard, if not impossible, to buy land and make rentals work in some markets. Certainly in Manhattan you cannot do that. But we believe in cities like New York. We believe in the rise of the creative class. We believe that the two largest parts of the population—the baby boomers and their children—are going to want to be in cities, because they have no dependents in their house, which I fully believe. We believe that jobs, the best jobs, are moving to the urban areas.

But you're talking about buying up land now because prices are rising. Is the window of opportunity for multifamily about to close?

Every market is different. We're trying to create an environment where we can get the assets affordably and [are] looking to hold them 20 years. Look at how wealth has been created in real estate over a very long period of time—it's holding assets in markets where rents appreciate faster than inflation. That's our business plan with multifamily.

Where do you see that scenario playing out?

We're going to see downtown Los Angeles double its stock of rental housing. And so the question with downtown Los Angeles is like the question with Williamsburg [in Brooklyn]. Williamsburg reached a tipping point and then became its own location. When you look at Williamsburg, you think, "Oh, that's just an extension of New York City." And the question now is: Will downtown Los Angeles become an extension of the rest of Los Angeles? Because to date it's been isolated. We're at the tipping point.

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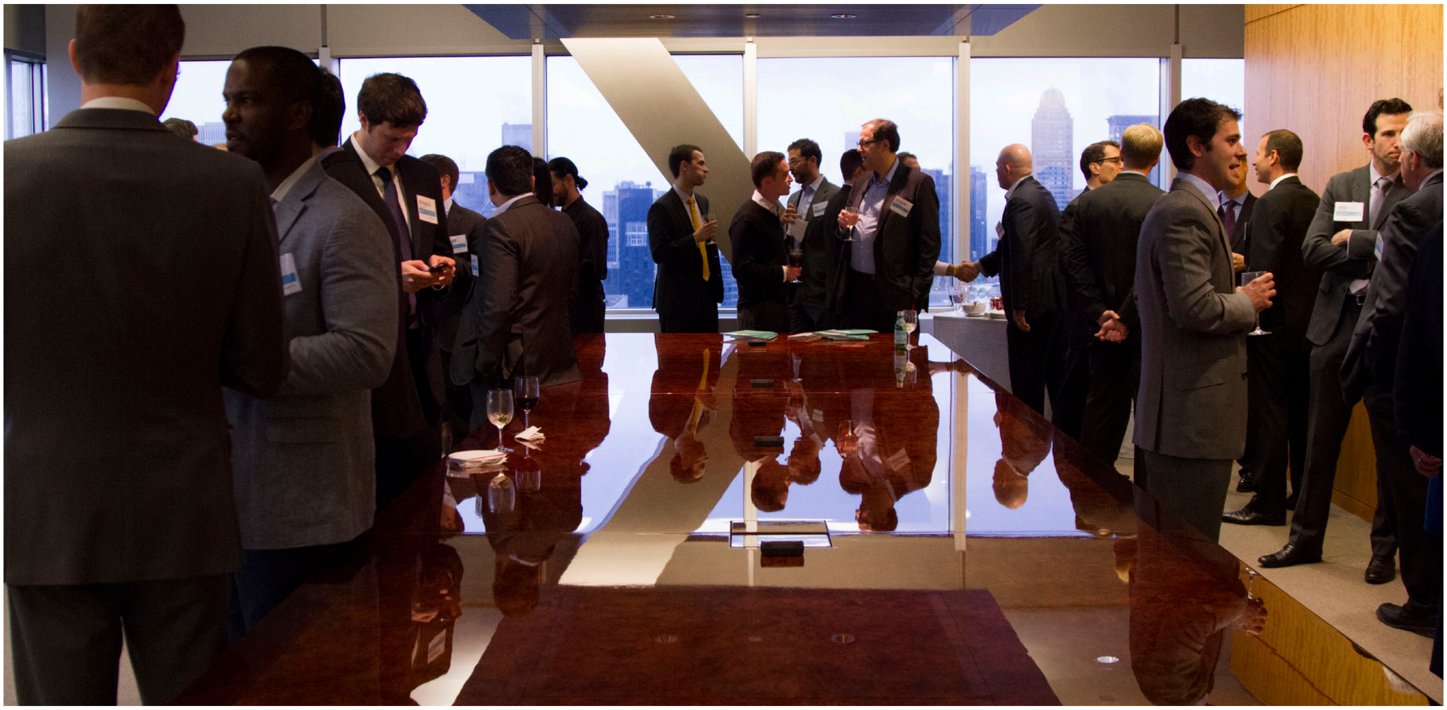

Attendees networking at the March 31 PrivcapRE Presents event, featuring Mack Real Estate's Richard Mack

> **"We're trying to create an environment where we can get the assets affordably and [are] looking to hold them 20 years. Look at how wealth has been created in real estate over a very long period of time—it's holding assets in markets where rents appreciate faster than inflation."**
>
> –Richard Mack, Mack Real Estate

Let me ask you about capital flows and where you see commercial real estate headed. Do some of the cap rates make your head spin in terms of the prices being paid for deals?

Prices are really high, interest rates are really low, and leverage is still modest. And the economy is starting to grow. So I don't think that we are in a bubble yet. There are places where assets are overvalued. But what's very different this time is that… [actually] I don't think it's different this time. Which leads me to conclude that we have a few more great innings to go. There is discipline in the lending community. There is not an abundance of high-leverage debt, and to the extent that that capital is available, it's priced appropriately.

Are banks cutting back their lending? And how will that affect the direct-lending business you started by hiring Peter Sotoloff from Blackstone Group?

Where banks are retreating, we want to enter. Corporate middle-market lending today is dominated by private lenders. Banks have completely retreated, and that is occurring or has occurred in what I'll call "transitional loans" in real estate. We brought Peter on to build a platform around our informational execution advantages. We have the ability to take over projects and development if we ever want to get an asset back, the ability to underwrite the execution capability of borrowers, and a capital-markets trading desk through a real estate securities hedge fund that we also retained in the AREA sale. So we think putting all those things together makes us a pretty good lender.

How do you view the outlook for commercial property?

As it relates to cash-flowing assets, pricing for capital in that part of the market has become very, very tight, because it's a place where many people can compete. And there is a great search for yield. I don't think that we're in an overleveraged situation yet. But given two years, we will be.■

Expert Q&A

With Kelly Ryan
Partner, Private Funds Group
Kirkland & Ellis LLP

What's the biggest trend you've seen in fund formation, given the scale of capital now targeting real estate?

One of the most noticeable changes is the emphasis and significance of co-investment structures. There is certainly a significant investment in creating a co-investment program that works for both the sponsor and its investors, but once it is established, it becomes a differentiating factor in the fundraising process. This is a trend that will continue to grow—it is a way for investors to increase their allocation with sponsors in certain strategies, participate in the investment process, and achieve more favorable economics. At the same time, it gives the sponsor the flexibility to pursue a wider range of transactions.

Are we seeing the need for GPs to offer more bespoke structures to investors?

In real estate private equity, we've always seen bespoke structures being offered, but we are seeing that now more than ever. Investors are often coming to the table with structures they believe work for them, and there is often an expectation on the part of the investor that the GP will accommodate that structure. As a result, the fund structures are continuing to get more complicated and/or are being tailored based on the increasing prominence of non-U.S. investors in real estate funds, coupled with the concerns of U.S. investors. It is also essential that these bespoke structures don't impede the fund sponsor from making attractive and profitable investments.

Does this mean more GPs are expanding their mandates and strategies as they offer a wider range of vehicles for investors?

We do see many real estate sponsors adding additional types of funds and accounts. In particular, we have seen a meaningful uptick in open-ended and other longer-life vehicles, which are usually structured for core and core-plus investments. On the other hand, a significant percentage of fund sponsors view the single strategy as the best outcome for their investors.

Is the weight of capital currently targeting real estate here to stay?

It's here to stay. There is an ever-increasing emphasis on the role of real estate in the portfolio of U.S. and non-U.S. investors. This is obviously a cyclical business, but the historical data does not suggest that allocations will decrease. enough to be able to act on deals in a relatively short time frame. Deals don't tend to hang around.■

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KIRKLAND & ELLIS

Richard, the cause that's really close to your heart is the Robin Hood Foundation. They're trying to tackle poverty and develop more affordable housing and homeless shelters in New York City. How did you get involved, and why is it so personal to you?

Richard Mack: We have a tremendous economy in New York, but the difference between the haves and have-nots does not seem to be narrowing. More than 1.8M New Yorkers live in poverty, 30 percent of children in New York City live in poverty, and 20,000 children live in homeless shelters. If those statistics don't make you lose sleep at night, I don't know what will.

How does your work with Robin Hood help solve those problems?

Mack: We're trying to engage the real estate industry in New York to help fix this problem. When I met with the folks at Robin Hood and they asked me how I might want to get engaged here, I said, "Let's tackle the problem that is tangible to people who work in real estate in New York: homelessness and lack of affordable housing." So we created the housing advisory board at Robin Hood.

The advisory board is raising a real estate fund. Tell me about that effort.

Mack: With just a little bit of high-risk capital, we think we can move the needle quite a bit and contribute to the creation of a lot more housing. We can't do it on our own. We're working with the government to try to increase the programmatic availability. And with regard to this fund, our goal is not to make 10, 15, 20 percent returns. We as a board are going to cover the overhead of managing the fund, so a 1 percent return or a 2 percent return actually turns into a 1 percent or 2 percent return.

Looking ahead, what are the long-term goals of the Robin Hood fund?

Mack: Our goal is to hopefully get the money back so we can reinvest it in another project, such that we can attract capital that has a public-minded agenda like endowments and pension funds to help us accelerate the investment. This is something that's near and dear to us, and that can be fixed with a little bit of capital, intellectual firepower, and a lot of elbow grease.

Robin Hood is New York's largest poverty-fighting organization, and since 1988 has focused on finding, funding and creating programs and schools that generate meaningful results for families in the city's poorest neighborhoods. Since its founding, Robin Hood has raised more than $1.95B in money, goods, and services to provide hundreds of the most effective soup kitchens, homeless shelters, schools, job-training programs and other vital services that give New York's neediest citizens the tools they need to build better lives. For more information, visit: https://www.robinhood.org ■