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Minority Report

By taking a minority cut in trophy assets, Madison provides an exit strategy for antsy investors

By John Salustri

As we prep for 2013, the watchword remains "caution," even as the economy (and therefore commercial real estate) travels its sluggish path to recovery. This year's *Emerging Trends*, the annual opus of ULI and PwC, said it best: "As investors tentatively advance further along the risk spectrum in 2013 chasing yield, they suffer queasiness about the limitations of US real estate markets. There is just not enough product to get the yields they want." Add to this slow-to-improve fundamentals and lingering concern that Europe's fiscal crisis could waft this way, and the challenges facing would-be sellers of product comes into stark relief.

It's particularly angst-inducing for minority stakeholders, the players who have just a piece of the action and are waiting on the major owners to determine their strategy. In such fractional—and sometimes fractious—ownership situations, the underlying investors, who thought their payoff was finally at hand, are being told to hold their water for another few years.

"We allow those investors to monetize or repatriate their legacy capital allocations." So says Ronald M. Dickerman, president of Manhattan-based Madison International, a private equity firm that has made its mark in secondary capital and switching positions with antsy minority-stake players. Dickerman says he'll transact anywhere from a 5% stake up to 49%, most typically in the upper reaches of that range, only occasionally going to a larger bite.

"You have broken, tired capital structures," Dickerman believes. "Even though cap rates have compressed and values have come back, rental rates haven't recovered to their high-watermarks in most major cities. In New York, rental rates were $85 to $90 a foot. Now, they're $50, $60, $70. Only in prime buildings have they gone back to well over $100. There's still a lot of residual effect from the credit crisis that hasn't been fully wound through the system as it relates to those capital structures and the disposition of investors." The result is a wait-and-see, the proverbial can being kicked down the road, and Madison's strategy is to capitalize on breaking the ownership logjam.

Such as it did recently with its purchase of a 25% stake at 655 Madison Ave., home to Loews Corp. and Donna Karan's New York flagship. "We bought it from a New York-based foundation that had come to the end of its charitable giving life," explains Dickerman. The foundation had to issue the remainder of its principal to its beneficiaries, and much of that was tied up in 655 Madison.

But as Dickerman explains, "The air is very thin for potential institutional buyers who could write a $15-million check to buy a partial stake in a commercial real estate asset." Madison became the foundation's White Knight.

It's a formula that seems to be working, and Dickerman boasts of volume that's been "significantly enhanced. We've had a record run in the past 12 to 18 months in terms of deal flow and capital deployment." With roughly $1 billion in equity invested, Madison has a portfolio that spans the US and Europe, with the bulk of that housed stateside.

The strategy is counter-cyclical, says the company leader, and the investment stance is passive—depending on how you define that. "In times of economic dislocation," says Dickerman, "investors look to liquefy in a higher velocity their partial ownership positions, so our business takes on a counter-cyclical element."

In terms of passivity, in a high-profile industry, Madison is content to take the smaller part. It's what Dickerman refers to as the "temperament" of its capital. "So many real estate investors are focused on the old thesis of ego and control: 'It's my building, and I will make all of the major decisions.' " Madison checks its corporate ego at the curb, he says, in order to be "passive financial investors with best-of-class sponsors who have a history of value-creation." In that capacity, Madison has had JVs with the likes of Forest City, Hines and Tishman Speyer—many on a repeat basis—and these relationships "are key to the way we source investments."

As passive investor, Madison looks to "someone else to manage and lease"—to do all the active ownership functions, according to Dickerman. But passive doesn't mean blind, and negative control rights are clearly in the investor's game plan, "where we can approve budgets, leasing, financing issues and ultimately outside sale timing of the property itself. These can be proposed by our partner and subject to our approval. That's different from a traditional opportunity fund where it is their absolute sole discretion on every decision." Madison's sweet spot is a six-to-seven year hold.

"We want to do whatever we can to allow our partners to achieve their business plans," Dickerman suggests. "Once we determine the holding period, we structure a dual-pronged option." The first prong is the more obvious sale to a third party at the highest price. Alternately, the JV can value the building, run that valuation "through the waterfall of our respective interests and redeem our interest at the appraised value using a refinancing of the underlying property." This, he explains, gives the venture the option to retain ownership if they see additional value creation.

Forest City Ratner's development pipeline is a massive beast to feed ("Whopping," says Dickerman), and to sate that hunger, the

developer entered into an agreement with Madison some 18 months ago. Through its $500-million Liquidity Fund IV (now some 80% invested, it's the same fund that capitalized 655 Madison), Dickerman and company cut an equity check for $180 million and ended up with a 49% stake in roughly $950 million worth of core assets. This includes two buildings directly across from Barclays Center, the recently opened sports/entertainment venue.

"It was a win-win," Dickerman recalls. "Our basis was about a 7.4% or 7.5% cap rate. At the time we closed, the assets themselves appraised in the low sixes. They got the liquidity they sought and a JV partner with a long-term view, and we got to make an investment in a core New York retail portfolio." What's more, that portfolio is 99% occupied with average remaining lease terms topping eight years. "But the quid pro quo is that we got somewhere around a 150-basis-point cap rate premium as opposed to what we would have paid if we bought the assets directly."

While Madison International does play on the European scene, it does so these days with sensible caution, and Dickerman admits the turmoil there gets him a bit nervous. In the overheated London market, for instance, there's a serious disconnect between risk and return. "We haven't seen the kind of rental-rate recovery that would be consistent with the type of pricing investors are asking for in prime office buildings. We've also seen quite a few fractional holders who are looking for liquidity, and we're actively pursuing them."

Elsewhere across the pond the financial upheaval is creating opportunity, but "we're raising the bar on anything we do in Europe. We're investing on the basis that the euro will survive, but I can't guarantee every country will remain euro based."

So Madison International remains true to its name by looking selectively in Europe for prime office buildings with underlying long-term, investment-grade credits, "where we can get paid to wait out the credit crisis and harvest a 6% to 8% dividend yield," says Dickerman. He also wants to buy in at an off-market rate. "That's how we're investing in Europe now." While he expects those opportunities to increase, he will remain selective, and the US continues to be Madison's prime focus, garnering 65% to 75% of its investment dollars.

Madison's European search is not for distressed assets, he makes clear, but "perfectly good, long-term leased buildings with what I'll call fatigued capital structure." He's seeking equity investors that need liquidity without leverage as well as deals that have gone on too long. "Maybe the investor has problems elsewhere in its portfolio and it's decided to sell a piece of the good stuff to defer liabilities on some of the troubled assets."

Dickerman, along with most successful players in commercial real estate, is an optimist at heart. But he admits the economy has him worried. A little.

But since he can't whittle down the national debt, the best he can do is mitigate the company risk through strategic focus, "sticking to core real estate in major metropolitan markets," he explains, "24-hour cities and assets with long-term leases, and keeping our leverage ratios very low." ◆

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Ronald M. Dickerman's Madison International has had "a record run" in an era of "broken capital structures."

Photo by Nick Koutoufas