# PSERS VALUE-ADDED REAL ESTATE PROGRAM

## Recommendation for Investment in
## Madison Marquette Retail Enhancement Fund, L.P.

Charles J. Spiller
Director of Alternative Investments

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# Madison Marquette Retail Enhancement Fund, L.P.

## EXECUTIVE SUMMARY

Madison Marquette, a nationally recognized retail real estate investor and operator, is sponsoring Madison Marquette Retail Enhancement Fund L.P. (the "Fund"), a private vehicle that will continue the company's proven investment strategy of repositioning, redeveloping, and / or developing retail and retail mixed-use real estate in major U.S. metropolitan markets. An established leader in the transformation of underutilized locations into vibrant destinations, Madison Marquette's unparalleled ability to capitalize on evolving consumer living and purchasing preferences creates a competitive distinction for the Fund. The Fund will target in-fill locations in high-growth markets, including Los Angeles, San Francisco, Seattle, the Twin Cities, Washington, D.C., Philadelphia, New York / New Jersey, and Southern Florida.

The Fund will seek $350 million of equity capital commitments and target a gross internal rate of return ("IRR") of 18%, with leverage representing no more than 70% of total portfolio cost. Madison Marquette and the Fund's investment team will commit a minimum of $60 million to the Fund.

Led by Mr. Amer Hammour, Chief Executive Officer, and Mr. Gary Mottola, Managing Director and Head of Investments, the Fund possesses a dynamic and complementary combination of real estate investment and retail operating expertise. The Fund's investment team will be comprised of Messrs. Hammour and Mottola and five senior investment professionals, supported by a team of investment, development, and research associates. The senior members of the investment team each have, on average, 20 years of real estate investment experience.

## THE SPONSOR

Founded in 1992, Madison Marquette is a fully integrated retail real estate operating platform headquartered in Washington, D.C. The Fund's investors will benefit from Madison Marquette's: (i) local presence, through 350 professionals and employees in 10 regional offices located nationwide; (ii) comprehensive asset management, leasing and brokerage, construction and development, property management, and retail consulting expertise; and (iii) broad network of relationships with premier retailers and local government officials. Very few of the Fund's competitors offer a similar array of value-added services and operational capabilities.

Madison Marquette, a leading creator of lifestyle centers, has been at the forefront of several innovations in the retail property sector, recognizing the trend toward community environments nearly 15 years ago. Madison Marquette has applied this creativity to other successful retail concepts, including the redevelopment of urban projects with retail and residential components and the re-formatting and conversion of underutilized retail space.

Madison Marquette's substantial institutional investment experience stems from partnerships with several prominent institutional investors over the past 13 years. Such investors include AEW Capital Management, BlackRock Realty, CUIP (a partnership on behalf of a public retirement system), the Harvard Endowment, JP Morgan Investment Management, and the Principal Life Group.

Madison Marquette is wholly owned by Capital Guidance, a privately held, international investment company with offices in Washington, D.C., Paris, and Geneva. Capital Guidance has been an active investor internationally for over 40 years. The company's activities have been focused on three main areas: real estate, long-term strategic investments in selected operating businesses, and financial investments in marketable securities and private funds.

## THE RETAIL MARKET

The retail real estate sector has enjoyed among the highest risk-adjusted returns relative to the four major property sectors. Resilient retail sales, along with today's strong market fundamentals, support an investment strategy focused on retail and retail mixed-use real estate in the Fund's target markets.

**Low Volatility in Occupancy and Rents.** The stability of retail real estate returns is supported by favorable historical trends in both vacancy rates and rental rate growth. For instance, retail vacancy rates are typically not impacted during periods of economic weakness. Over the past 15 years, retail vacancy rates have typically remained in a narrow range of 9% to 10%. When the economy weakened during the early 1990s and 2000s, retail vacancy rates only climbed slightly (the highest rate being 11.1% in 1991). Office and industrial vacancy rates have fluctuated much more widely, indicating much greater vulnerability to economic cycles. Only the multifamily sector exhibits similar stability as retail.

**Economic Growth Supports Retail Property Investors.** The continued strength of the retail property sector is supported by a growing U.S. economy. Given the high historical correlation between U.S. gross domestic product ("GDP") growth and U.S. retail sales – 86.3% for the period 1991 to 2004 – economists project robust retail sales growth over the next few years.

**Controlled Supply Levels and Declining Vacancies.** Retail property return stability can also be attributed to controlled levels of speculative construction in the retail property sector. Over the period 2000 to 2004, retail construction levels declined by 8.6%. Construction has remained tenant-driven, as many of the larger retailers have indicated a preference for build-to-suit projects. As a result, projections for new development over the next three years are in line with historical levels and vacancies are expected to decline from 9.2% in 2004 to 7.7% by year-end 2005, and remain relatively constant through 2007.

**Increasing Preference for Urban Areas.** Over the last two decades, population gains have been concentrated in urban areas. Nationwide, the metropolitan area population continues to grow while rural areas show population declines. Over the period 1990 to 2000, population growth in urbanized areas in the United States was 21.5%, versus 13.1% for the nation as a whole. Meanwhile, the population in non-urbanized areas declined by 1.5%. Between 2000 and 2010, the number of U.S. households is projected to increase from 105.5 million to 117.2 million. The majority of this growth is occurring in urbanized areas, with growth in urbanized areas outpacing the U.S. average by over 8%.

A large segment of the population enjoys urban living and the urban experience, a key reason underlying the development of the lifestyle shopping centers that are designed to duplicate it. Empty Nesters have begun to move back to the cities, joined by young professionals, both singles and couples, seeking the excitement and variety of urban living. This shift is behind a resurgence in urban residential development, which is not restricted only to downtowns, but also is behind growth in other urban in-fill locations – beautiful old neighborhoods that offer urban living in a more suburban setting. This, in turn, has spurred retail development that takes several forms: adaptive re-use, historic preservation, and new construction, all combining to create the streetfront retail experience popular today.

**Resurgence of Community "Focal Points" in Non-urban Areas.** In the burgeoning areas surrounding central cities, Madison Marquette has identified an opportunity to provide suburban counterparts to the urban downtown. Suburbs have been criticized for their general uniformity, inefficiency, and lack of community. Suburban residents are demanding what urban residents enjoy: a central location offering employment centers, shopping, community centers, entertainment, medical facilities, schools, parks, and recreational facilities. The emergence of lifestyle centers, built to echo urban retail streets, shows the desire people have for an urban shopping experience, even if developed from the ground up. There is a tremendous opportunity to provide the elements that the typical suburb lacks and, thus, establish a leading and dominant position in key suburban markets. Lifestyle retailing would anchor such districts, appealing to the upscale and prosperous households moving into such projects.

**Conversion and Re-formatting of Obsolete Space.** In keeping with its urban emphasis, Madison Marquette also has identified an opportunity to re-format obsolete space. Outdated designs often lead to a shopping center's decline, even though it may be located in a strong location. A market's changing demographics, especially in areas seeing an influx of upscale suburbanites moving back into the cities, requires that the existing retail districts reposition themselves in order to stay abreast of these market shifts. Department store closings, often due to consolidation in the industry, have resulted in the availability of numerous well-located buildings in growing and prosperous communities. In all cases, major urban and suburban markets are fertile ground for redevelopment and repositioning to serve these prosperous neighborhoods.

## WELL-DEFINED STRATEGIES

The Fund expects to capitalize on dynamic consumer living and purchasing preferences by creating locations that are specifically designed to serve as community focal points. The major trends that the Fund's strategy is expected to address are:

- Empty Nesters and young professionals are expressing a growing preference for city living. This will continue to create demand for urban retail and retail mixed-use projects.
- People living outside urban areas are seeking community focal points. This will create demand for "community villages" and next-generation lifestyle centers.
- Regional shopping centers are projected to continue to lose customers and viability. This presents an opportunity for real estate operators to acquire retail centers in strong locations, redevelop the properties, install a more up-to-date tenant mix, and / or re-format assets for alternative uses.

The Fund expects to invest in three major product types:

**Urban retail and retail mixed-use opportunities.** Serving the rapidly increasing demand for urban living, the Fund expects to create opportunities for retailers to establish urban locations. These "downtown" projects may also include a residential component. The success of these properties will be driven by retailers' need to be near high-income demographics, for which they are willing to pay high rents.

**Community villages.** The Fund expects to invest in a new "community village" model, incorporating retail, services, entertainment, dining, and, in some cases, offices, close to where consumers live. Leveraging Madison Marquette's expertise in the development of lifestyle centers, the Fund plans to create open-air concepts that focus on a combination of high-end and specialty retail. This format has gained wide acceptance among consumers, who find these venues attractive due to their convenience, ease of shopping, ambience, quality retail offerings, and security.

**Conversion and re-formatting of underutilized retail space.** The Fund expects to leverage Madison Marquette's extensive relationships and market knowledge to selectively acquire underperforming centers and "excess" real estate from department stores and other retailers. In strong locations, these projects can be re-formatted for consumers who have demonstrated a growing preference for specialty retailers rather than "one-size-fits-all" department stores. In addition to seeking to re-tenant vacant urban department stores, the Fund expects to bring "big box" and other national tenants into previously distressed retail projects with strong existing access and visibility.

The Fund will seek to create exceptional value from the projects it acquires through a variety of active techniques, including:

**Re-merchandising and revitalizing** the tenant mix and actively managing more stable assets to improve net operating income and property performance. By increasing tenant quality and enhancing operating performance, Madison Marquette expects to reduce the exit capitalization rates for the Fund's investments.

**Redeveloping under-performing assets** by replacing or enhancing existing tenancy with new, stronger national retailers. The Fund also expects to enhance the configuration of existing assets to add incremental income-producing square footage, including redeveloping and expanding properties where there are existing structures.

**Developing new projects in limited circumstances.** Ground-up development will be undertaken in certain instances where there is proven retailer demand and exceptional demographic strength.

**Mixed-use additions.** In select situations, Madison Marquette may obtain entitlements to add residential units to an existing retail project when such activity is supported by supply and demand fundamentals.

## MANAGEMENT OF THE FUND

**Amer Hammour**. Mr. Hammour is founder and Chief Executive Officer of Madison Marquette. He is responsible for Madison Marquette's investment policy and operating strategy. He brings 22 years of in-depth experience in real estate acquisitions, land and commercial property development, private equity placements, fund investments, and operating company acquisitions and has completed real estate transactions with an aggregate value of $2.5 billion. Mr. Hammour has served as an executive and is currently an active board member of Madison Marquette's parent company, Capital Guidance, and some of its portfolio companies. Mr. Hammour holds a Master of Science degree in Management from the Sloan School of Management at the Massachusetts Institute of Technology and a Bachelor of Science degree in Industrial and Systems Engineering from the Georgia Institute of Technology. He is a board member of the Association of Foreign Investors in Real Estate.

**Gary Mottola**. Mr. Mottola joined Madison Marquette in 2002 and since then has been responsible for all of its investment activities. As Managing Director and Head of Investments, Mr. Mottola will be responsible for the investment activities of the Fund, including sourcing and deal selection, underwriting, structuring, portfolio management, and dispositions. Prior to joining Madison Marquette, Mr. Mottola was a partner specializing in real estate at Simpson Thacher & Bartlett for over 20 years, where he represented numerous financial institutions, joint ventures, and real estate companies in equity and debt financings, real estate development, acquisitions, and sales, both in the United States and abroad. During this time, he also served as an outside advisor to Madison Marquette at its formation and in connection with all of its strategic activities. Mr. Mottola received his undergraduate degree from Harvard College and his law degree from the University of California, Berkeley.

**Paul Andrews**. Mr. Andrews serves as Chief Financial Officer and oversees Madison Marquette's corporate finance, accounting, administration, and support activities, as well as the company's disposition program and lender relationships. Prior to joining Madison Marquette, Mr. Andrews was a Vice President with Marriott International and led Marriott's Corporate Accounting Team, playing a key role in the company's acquisition and disposition programs. He also served as Chief Financial Officer of Gold's Gym International, leading its acquisition program and managing relationships with equity sponsors and banking syndicates. Mr. Andrews brings 10 years of industry experience and has been closely involved in real estate transactions with an aggregate value in excess of $1.5 billion. He began his career with Arthur Andersen in England, transferring to their Washington, D.C. office in 1993. Mr. Andrews holds a Bachelor of Science degree (Upper Second Class) in Physics from the University of Manchester, England. He is a Certified Public Accountant and holds Chartered Accountant status in England and Wales. Mr. Andrews maintains affiliations with the International Council of Shopping Centers, the American Institute of Certified Public Accountants, and the Association of Chartered Accountants in England and Wales.

**David Brainerd**. Mr. Brainerd is a Managing Director, responsible for sourcing, negotiating, and closing property acquisitions and overseeing investment management and disposition of owned properties. Mr. Brainerd also manages relationships with existing equity partners and has supervised investments representing over 2.5 million square feet of shopping centers, 1.4 million square feet of office space, and approximately 7,000 acres of land for Madison Marquette and while serving as a Senior Vice President for Capital Guidance. Mr. Brainerd began his career with the Mortgage-Backed Securities team of First Boston Corporation's Real Estate Finance Group. He was responsible for the underwriting of large Port-folios of commercial and residential mortgage loans for purchase and securitization by the firm. Mr. Brainerd brings 19 years of industry experience, and has been involved in real estate investment transactions with an aggregate value of $1.5 billion. Mr. Brainerd holds a Masters degree in Management from the Sloan School of Management at the Massachusetts Institute of Technology and a Bachelor's degree in Finance from the University of Massachusetts at Amherst. He is a member of the Urban Land Institute, where he serves as Vice Chair of the Commercia and Retail Development Council (Silver Flight), and the International Council of Shopping Centers.

**Thomas Falatko**. Mr. Falatko is a Managing Director, responsible for sourcing, negotiating, and closing retail real estate projects in the Southeastern United States and Southern California. Before joining Madison Marquette, he was Director of Acquisitions for Combined Properties, a Washington, D.C.-based private owner and operator of retail properties. He brings 16 years of real estate experience to the investment team, and has been involved in real estate transactions with an aggregate value of approximately $1 billion. His previous roles include that of Acquisition Officer for Federal Realty Investment Trust, Asset Manager for J.E. Robert Company, and Vice President of Interstate Equities Incorporated. Mr. Falatko holds a Masters degree in Real Estate from Johns Hopkins University in Baltimore, Maryland and a Bachelor of Science degree from Virginia

Polytechnic Institute and State University in Blacksburg. He is a member of the Urban Land Institute and the International Council of Shopping Centers.

**Eric Hohmann**. Mr. Hohmann is a Managing Director, responsible for Madison Marquette's investment activities in Northern California. Prior to joining Madison Marquette, Mr. Hohmann was Vice President of Development and Acquisitions for The Irvine Company, where he managed development activities for multifamily residential projects in Silicon Valley. He also served as Senior Vice President in the Real Estate Division of JMB Realty Corporation, managing property sales activities for a 54,000-acre, Hawaii-based, mixed-use land development portfolio. Mr. Hohmann has 19 years of real estate investment experience and has completed real estate transactions with an aggregate value in excess of $1 billion. Mr. Hohmann holds a Masters degree in Business Administration (Finance) from the John E. Anderson Graduate School of Management at the University of California at Los Angeles and a Bachelor's degree *(magna cum laude)* in Chemical Engineering from Vanderbilt University. He is a member of the Urban Land Institute.

**Jay Lask**. Mr. Lask is a Managing Director, responsible for sourcing, negotiating, and closing property acquisitions in the Northeastern and Central regions of the United States. Prior to joining Madison Marquette, Mr. Lask was a Senior Vice President at First Washington Realty, where he oversaw all aspects of the firm's national shopping center acquisition program, including deal selection and structuring, investment underwriting, pricing, contract negotiation, due diligence, and closing. Mr. Lask also spent 16 years with Lend Lease Real Estate Investments in progressively responsible positions, most recently as Chief Retail Acquisition Officer. He brings 21 years of experience in real estate investment and has completed real estate transactions with an aggregate value of $1.5 billion. Mr. Lask holds a Masters of Business Administration from Emory University and a Bachelors degree in Urban Planning from the University of Cincinnati. He is a member of the International Council of Shopping Centers.

## CONCLUSION/RECOMMENDATION

Based upon the successful track record and experience of the principals and the recommendation of PSERS' consultant, Courtland Partners, Ltd., staff recommends that the Board invest an amount equal to 25 percent of the committed capital, but not to exceed $125 million plus reasonable normal investment expenses, in Madison Marquette Retail Enhancement Fund, L.P. The final terms and conditions of the investment must be satisfactory to the Investment Office, the Office of Chief Counsel, and the Executive Director.