

The Sacramento Bee

Urban projects pay off for CalPERS

Pension fund's ahead of the pack with decision to take a gamble on developments in cities

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Published 2:15 am PDT Sunday, September 4, 2005

EMERYVILLE- Victor MacFarlane strolled along the fashionable gateway of a city once known for industrial plants and factories, surveying the shops and rows of second-story town houses and apartments under construction.

He stopped across from the P.F. Chang's China Bistro on Bay Street as cars and trucks whizzed by a few hundred yards away on Interstate 80.

"The people who live here can walk to the restaurant, go shopping and go to the movie theater - all without getting into their car," the San Francisco real estate adviser said. "That's real nice living."

With Bay Street and dozens of other projects around the nation, the pioneering California Public Employees' Retirement System is showing that investments in urban projects can pay off with double-digit returns despite environmental and bureaucratic challenges.

MacFarlane and a dozen other real estate advisers, backed by the \$190 billion CalPERS fund, are reshaping and reinvigorating urban communities and blighted neighborhoods across the country with housing, office and retail projects such as Emeryville's Bay Street.

CalPERS, the nation's largest public pension fund, has been at the forefront of an ambitious urban real estate investment program shunned for years by most institutional investors.

"It's not a traditional place for pension funds to invest in. It takes some courage for what they've done," said Robert Edelstein, co-chairman of the Fisher Center for Real Estate and Urban Economics, a leading research institute at the University of California, Berkeley.

CalPERS money has flowed to urban projects from Sacramento to San Diego to New York City. They include:

- * The \$46 million Plaza Lofts, a 225-unit, seven-story apartment and retail project near Cesar E. Chavez Plaza in downtown Sacramento.

- * Renovating deteriorating buildings for retail outlets, restaurants, loft apartments and parking in San Diego's historic Gaslamp Quarter.

* A complex that includes the famous Kodak Theatre, home to the Academy Awards ceremony, in the famed Hollywood Boulevard district.

* The Ladera Center, named for the southwest Los Angeles neighborhood in which it lies. After acquiring it, MacFarlane traveled regularly to Los Angeles to work with community members on shaping the center.

"I wasn't afraid to go into a black community," he said. "We were willing to understand those areas."

* A development that recruited Ralphs to downtown Los Angeles, the first major supermarket in the area in 50 years.

* Low-income housing in San Bruno.

Senior citizens Remedios Fernandez, 75, and her 77-year-old husband, Federico, have a new one-bedroom unit at Meridian Apartments near San Francisco International Airport after living for some time with one of their daughters.

"You cannot find a decent apartment that is affordable," Remedios Fernandez said. "It was a dream that came to realization."

CalPERS and real estate executives are quick to spell out that the fund's California Urban Real Estate program is no feel-good, social investment initiative like the city redevelopment projects of years past. Foremost, they say, the fund is out to make money for the 1.4 million state and local government workers and retirees.

"CalPERS is making a good business decision. This is a real estate play that diversifies its portfolio," said Paul Lapides, director of the Corporate Governance Center at Kennesaw State University in Georgia.

Since CalPERS made its first urban investment in 1997, the program has generated \$106.6 million in profits overall and produced an internal rate of return of 20.2 percent.

An industry consultant concluded that the managers of CalPERS' urban real estate portfolio have produced investment returns in a seven-year period that are nearly double those of their peers overall.

"You're trying to do something that no one is doing. It takes courage to step away from the pack. There is additional risk," said Mark Anson, Cal-PERS' chief investment officer. "The returns have justified the investment program."

CalPERS has allocated \$3.4 billion to 13 real estate investment firms, but so far, just \$1.2 billion has been invested in projects.

More than three-quarters of the invested funds has gone to projects in California. Most of the out-of-state funding went to a new retail and parking complex in the sprawling Time Warner Center in Manhattan.

In recent years, other pension funds and institutional investors have started pumping money into urban real estate. The California State Teachers' Retirement System, the nation's third-largest fund, jumped in during the early 2000s and has allocated \$940 million to urban developments, including \$275 million for affordable housing in the state.

"There are a lot of people who see redeveloping the inner-city areas as a good investment," Lapides said.

But a decade ago, MacFarlane and other real estate advisers like him clearly stood in the minority. It took several years before MacFarlane could convince CalPERS that urban real estate could be profitable.

By 1995, CalPERS approved \$50 million for MacFarlane and basketball legend Earvin "Magic" Johnson and their California Urban Investment Partners fund. The group later purchased the 185,000-square-foot Ladera Center in a predominantly African American community near Inglewood. Since 1997, the center's same-store sales have increased annually.

"The perception of risk of investing in urban markets was very high," said MacFarlane, managing partner of MacFarlane Partners, the nation's largest minority-owned real estate investment firm. He is CalPERS' largest urban real estate partner, with \$1.2 billion in funding.

MacFarlane recalled that CalPERS trustees were nervous at first: "After the board meeting, a number of trustees said, 'Victor, we are counting on you not to lose money.'"

As CalPERS was considering its first urban investment, Harvard business professor Michael Porter published an article in Harvard Business Review advocating the competitive advantage of investing in blighted, urban areas.

Known nationwide for his research on urban renewal, Porter has said more compact urban populations offer greater spending power per square mile than the suburbs.

In 1999, a CalSTRS consultant's report said urban investments could generate a 15 percent annual net return. It estimated 7.7 million households with more than \$85 billion in retail spending power per year were living in the nation's urban core. But a quarter of the retail demand wasn't being met.

These findings sparked state Treasurer Phil Angelides, a trustee at CalPERS and CalSTRS, to launch an economic initiative in 2000 that included boosting pension fund investments in urban real estate.

"Our urban neighborhoods were being overlooked by traditional investors. Too often these inner-city markets were being written off as places of risk," said Angelides, whose role in the urban

campaign was recognized in 2003 by Porter's Initiative for a Competitive Inner City. "The private markets and private capital shunned these areas."

"Our timing was right. We moved into these markets before they became fashionable," Angelides added.

Pension funds, experts say, are better suited for urban real estate investing. As long-term investors, they can work patiently through the laundry list of obstacles facing urban developments, including bureaucratic red tape and environmental issues.

For example, it took developers some eight years to get Emeryville's Bay Street urban village project off the ground. The city first had to clean up the blighted 20-acre site, which once housed a pigment plant and foundry, among other things, and then a lengthy redevelopment process ensued.

"The barriers are high. It takes time," said Avi Shemesh, a principal with CIM Group, which has \$405 million in CalPERS funding and is spearheading downtown Sacramento's Plaza Lofts project.

Emeryville, which was attempting to build sales tax revenue and upgrade its image, used the 400,000-square-foot Bay Street complex, with its mix of town houses, apartments, restaurants, shops and 16-screen cineplex, as a major ingredient in an economic renaissance.

"It took a big financing package in order to make it feasible," said Patrick O'Keeffe, Emeryville economic development director. CalPERS stepped up with the equity commitment sought by lenders, he said.

Bay Street, O'Keeffe said, "is a good example of the kind of project that is a catalyst for revitalization."