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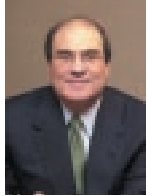

PricewaterhouseCoopers Real Estate Partner Larry Jones Interviews Charles A. Ratner, President and Chief Executive Officer of Forest City, Enterprises, Inc.

Forest City:

Building an American Success Story

FOREST CITY ENTERPRISES, INC. (NYSE: FCEA and FCEB) is one of the nation's leading public real estate operating and investment companies. From its inception in 1921 as a family lumberyard business, the company has benefited from the leadership and commitment of a close-knit family spanning three generations.

In 1960, Forest City became a publicly traded company and has continued to grow and diversify at a steady pace. Today, Forest City's large and diverse portfolio of properties is spread throughout 22 states and the District of Columbia and ranges from high-profile office buildings (such as the now under-development New York Times office tower on 42nd Street in New York City) to apartment communities to regional malls and specialty retail centers.

Headquartered in Cleveland, Forest City has total assets in excess of $5 billion and operates four strategic business units: Commercial, Residential, Land Development and Lumber Trading.

Recently, PricewaterhouseCoopers real estate partner Larry Jones sat down with Charles A. Ratner, president and chief executive officer of Forest City, to talk about the company's colorful history and its unique entrepreneurial approach to the real estate business.

PwC: In a lot of ways, the history of your company reads like the quintessential American Dream. Maybe we can begin by having you give us some insight into Forest City's roots — how the company originated and what makes it so unique.

CR: Forest City is a publicly traded real estate operating company. We have been in business for more than 80 years. Originally, the company was founded by a family of immigrants from Poland as a lumber business. In 1960, we went public. So we've been a public company for 40-plus years. Basically, we have been completely transformed from a lumber business into a national real estate development company. That is our core business today. It is 95 percent of what we do; it's a business that develops and owns investment real estate.

PwC: What made the company settle in Cleveland?

CR: That was strictly an accident of immigrant history, just as the way it is with almost every immigrant family in this country. The first relative that came here was a half-sister of the Ratner family who found her way to Cleveland by happenstance. Then a brother came later and joined his half-sister here in Cleveland. He's the one who started the business—the that was Charles, the one who I'm named after. Then when the rest of the family came, the parents and the eight children, they all came to join the brother, who by then was in the American army and had been somewhat of a success over 10 or 15 years. So they all came here and joined him here just because he happened to be here. It's no different than the story of the Irish, or Italians, or any other type of immigrant family.

Some stayed in New York. In fact, I used to ask my father: "Why didn't you just stay there? Why did you come to Cleveland?" I don't think there was any design to Cleveland; that's just how it happened. But it turned out that during all those years, from the late 1920s right through the 1970s, Cleveland was a great place to be because it was a center of industrialized America as it grew.

PwC: How did the family make the transition from a lumber business into real estate investment?

CR: The company started 80 years ago as a lumber business and began accumulating a little money. Then, when the Depression hit, a lot of land became available through tax liens in cities like Cleveland, Detroit, Pittsburgh, all these Midwestern industrial cities. Then World War II came and the automobile became popular. Suddenly, a country that had no garages started building garages by the thousands—and Cleveland was no exception; it was a big automobile center. In fact, garages were one of the company's biggest businesses back in the late 1930s, early 1940s.

After the war was over, Cleveland started to take off. From 1945 to 1950, the company's lumber business grew exponentially. The land that the family had accumulated suddenly became valuable as Ford, Chevrolet, Republic Steel and Bethlehem Steel all built huge facilities in Cleveland and suddenly there was a need for places for people to live. So the suburbs also started to grow, from little villages into cities of a hundred thousand.

So basically, the family accumulated this land during the Depression, then started to develop this land, because they saw it mainly as a raw product for their customers who were buying lumber. When refugees and veterans came back from the war—Forest City helped set these people up in business, by giving them a couple of lots on the land the company had developed and giving them the lumber to build the houses and we would say: "Pay me out of the first draw that you get." Builders went out and sold houses and garages and we built our lumber business by having land as part of the raw material because the builders couldn't afford to buy the land. They weren't the Pultes and the Ryans of today. The builders were all small businesses. We used the land basically as an item of inventory to support our lumber business.

PwC: That was a big part of your foray into the public markets, wasn't it?

CR: In 1960, when we went public, 80 percent of what we went public with was the lumber business—buying lumber and selling it to builders.

During the 1950s, when Cleveland really started to grow, the builders weren't using the land as quickly as they could develop it, so the family, while it was still a private company, started doing some of its own development. It actually built its first apartment building in the late 1940s, then its first strip shopping center with a supermarket in the early 1950s. That's when Albert Ratner and Sam Miller joined the business and started developing real estate more actively, but almost exclusively with partners. In some cases, these were local partners who were buying lumber from Forest City and they took an interest in a joint venture; in other cases, they were strictly real estate investment partnerships. This continued throughout the 1950s.

By the 1960s, Cleveland was growing very fast. At that time, Cleveland had 10,000 housing starts a year; now it has half that

number. So it was a very lucrative business and did very well when Bache and Company took us public in 1960.

Then as Cleveland began to come off that peak in new housing starts, Forest City began to convert these wholesale lumberyards into retail home centers, a precursor to Home Depot. There were chains like this all over the country—Hechinger's in Washington, Grossman's in Boston, Central Hardware in St. Louis. We built a chain of stores and, in fact, that was the first business I went into when I joined the company in 1966 out of law school. We had a chain then of five or six stores and it grew to 30 stores, expanding to Akron, Detroit and Chicago. We built a pretty good business.

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So we were growing in these two ways—the lumber business was growing rapidly, wholesale and retail, and the real estate business was growing. We soon became aware of the fact that we really couldn't grow both businesses competitively. We didn't have either the capital or the human talent, so we made the decision to sell the retail business. The timing turned out to be right—at that time, Home Depot was on the horizon and it was clear that in order to compete, we would have to put in large amounts of capital and build very big stores. So we sold that business and decided at that point that we were going to concentrate on the real estate business.

PwC: What is the basic focus of your real estate business today?

CR: Our real estate business today is characterized by three basic strategies—product and market diversification, our urban strategy and our capital strategy. In the markets today, there is a lot of emphasis on focus. Wall Street wants focus. Wall Street believes that if you're an apartment builder in the West, then you know that business well and you've developed core competencies. So they like developers who only do strip shopping centers, and they like the mall REITs and the office REITs and entities such as Equity Residential. There are occasional Vornados, but there aren't many other examples of diversified real estate companies. By and large, Wall Street likes focus.

Even though that's the popular strategy, we don't believe that's the best strategy for us. Being diversified by product and market doesn't mean we do everything. We are very, very focused on what it is we do, but it's not singular in either area. So we do apartments, and we're large—we're not one of the very biggest, but we have 35,000 units. We also develop retail centers and while we're not one of the eight major mall REITs in the country, we do have a critical mass that is a very high value proposition for us. We just opened Short Pump Town Center in Richmond, Virginia, where we competed successfully with one of the major mall REITs. Short Pump is a great open-air regional retail center. We're also doing a similar one in Rancho Cucamonga, California. And we recently opened Promenade in Temecula in California and Galleria at Sunset in Las Vegas. We've developed great retail centers and we love that business. We've been at it for 50 years and we have great relationships with our tenants. We think if you have the right location, you're going to have a great success. It doesn't matter whether you have 50 malls, 200 malls, or 20 malls.

So we like the retail business, we like the apartment rental business, and we like the office building business—largely in commercial business districts and largely in a few major concentrations such as New York, Boston and Cleveland, even though the market isn't that great here right now. We also like big mixed-use projects. And what is common about all of these is that this product and market approach is centered around what we call our "urban strategy." We like the urban markets. It's not a sandbox everybody likes to play in, but we think we're very good at it. The barriers to entry are very high—there are a lot of entitlement and subsidy issues and almost everything involves public-private partnerships because you need public support to do these major urban projects. But if you're successful in getting them, they can be extremely lucrative for both us and the local community. This has been our approach in places like Boston, Brooklyn, Cleveland, Denver, downtown Los Angeles and Richmond. It's very exciting stuff and there are very good returns if you can do it.

PwC: So the emphasis on diversification isn't really the counter-intuitive approach to Wall Street that people might initially presume?

CR: We like the diversification—but it's a focused diversification. We have residential, but only apartments. We don't do for-sale housing or condominiums or vacation housing or timeshares. We only do rental housing, but we do all kinds of rental housing—luxury rental, affordable rental, congregate living, assisted living—all rental product. In retail, our core business is the mall business, but we also like the specialty retail business. In New York City, we're the largest retail developer. There are also our office building and our mixed-use interests—such as MetroTech Center in Brooklyn, and University Park at MIT in Boston, where we have office and retail

and hotel and residential all in the same project. So in Boston, for example, we have this Cambridge partnership with MIT. We've been there for 15 years and we have two sites left. We've developed two million square feet of mixed-use product—one of the nation's largest biotechnology office parks. But now the biotech business is softer; we can't use these last two sites and our entitlement with MIT runs out soon, so we're going to turn them into residential opportunities and we expect them to do very well.

So we do like the diversification. First, it's a defensive strategy in that we're not dependent on any one place or product. But more than that, it's also an offensive strategy—a proactive strategy. What we've learned is that we can go into a market with one product and if it's good, then we can expand into that market with everything. We've done that in California, New York and Boston and we're doing it now in Denver. We think that's a great proactive strategy, where we're not confined to only the one product. If you develop the capacity in New York City to do office buildings—and office buildings go through cycles like everything else—you can convert that same expertise of getting the entitlements and finding the sites and developing, building and managing the project. You can convert that expertise to retail and now, it seems in New York City, into residential as well. We did just that with our Worth Street apartment building in downtown Manhattan, just outside of Tribeca in the Foley Square area; and it leased up in nine months. It is a very successful project and we think we can do more.

PwC: With respect to the markets, Chuck, as you said, you can't be all things to all people. I think a year or so ago, you put out in your annual report a discussion of your core markets. Could you go into that a little bit?

CR: Sure. The market strategy is interesting and it's very similar to our product strategy. We started out as a company in Cleveland, Ohio, which was a great market 50 years ago. Then we became a regional developer. We developed in Buffalo, Flint, Detroit and Kentucky—places like that; it was the next outward ring. Before we could become national, we had to become regional. Then 20 or 25 years ago, we decided that if we were going to grow and be public, we needed to get out of this part of the country because it was not where the growth was. So we went to the coasts. We made a proactive effort to get into Los Angeles and into New York City. Both have turned out to be terrific for us. The boroughs of New York City are now 25 percent of our company and California/Nevada is probably 15 or 20 percent of our company.

Here's what we've done. We've taken a business that as recently as eight years ago was 60 percent in what we today would call non-core markets. Today, our company is invested 65 percent in core markets and 80-85 percent of our new business is in those core markets. Those core markets are greater New York City, Boston, Denver, northern and southern California, and the Washington-Baltimore-Richmond area. Those are the core markets we are in today and we are likely to add one or two core markets over the next several years. We're looking at Florida as a potential core market; we've made a couple of acquisitions there, and there may be a couple of others. What we are working very hard to do is not so much to get rid of assets in the non-core markets, but to focus the new business in the core markets.

We're still doing some business in Cleveland with the joint venture partners that we have had for 40 years—as they build more units, we build with them—but by and large, the new business is going into these core markets. They are defined by markets where there are either markets of size or markets of growth. There are markets where there is intellectual capital—we think that's going to be a huge factor going forward, the concentrations of knowledge in places like Boston, New York and Los Angeles—where there are high incidences of patents being developed, high incidences of university-educated people, that kind of thing, because that is what we think is going to drive demand for our product.

"We use partnerships and we've used them for 80 years because we believe they offer an excellent opportunity to marry our expertise with someone else's, and to marry our expertise with someone else's capital."

PwC: One of the other things distinguishing Forest City is that you do a large percentage of your activity through joint venture arrangements. Could you tell us how you consider your joint venture relationships—there seem to be a lot of different joint venture partners in your case, as opposed to some companies that may concentrate on just a few big money partners. Your relationships seem more diverse.

CR: That takes us to another key issue for us—our capital strategy. We use partnerships and we've used them for 80 years because we believe they offer an excellent opportunity to marry our expertise with someone else's, and to marry our expertise with someone else's capital. To some degree, that is in order to share the risk—to take

some of the risk off of our balance sheet. So we partnered on the New York Times building project; we partnered with Westfield on the Emporium project in San Francisco because they are very large projects—six, seven hundred million dollars. We think that's just too big a risk for any one player and it's good to have someone who is very substantial, with a good balance sheet and who can help us both mitigate risk and pursue the opportunity.

Our joint venture strategy is like the diversification strategy in that they are both proactive strategies. By and large, you will find that the partners we have are of two main types. First, there is the old structure that we built the company on 40-50 years ago, which is largely local partners, some of them now in the third generation of the same family, where we go 50-50 on the joint venture with the money and either they or we build it and operate it. That's locally done stuff, mostly strip retail centers and apartments.

The second one is the type where we basically bring in this financial partner to help mitigate risk and to share the costs. The best example is where someone else owns the land or controls the deal and needs a developer who can pull it off. That's where we have really used these partnerships as a source of opportunity. For example, in Richmond, the Pruitt family has owned the Short Pump area land for 50, 60, 70 years. Seventy years ago, it was a two-hour ride from downtown Richmond to Short Pump; today, it's 15 minutes. They used to grow timber on this land. The father still lives in a farmhouse on the land. All of a sudden, they realized they have a great site. They wanted to build a shopping center, so they went out and talked to a shopping center developer and found that everybody wanted to buy their land from them. We said to them: "Look, we'll make you a joint venture partner. You don't have to pay tax on the land; you'll own the real estate with us. We'll develop it, we'll build it; we'll manage it. We'll do it all at competitive, market-based fees and we're in it for the same reason you are—not the fees, but for the value of the real estate at the end of the day. You put your land in, we'll put the money in and to the extent that we have a larger investment than you, we'll get a return on that money and then we'll split the rest."

We've done that with doctors in Las Vegas, with a family in Akron, with a family of merchants in Buffalo—and these are 30- and 40-year-old relationships. More recently, we've done it in Richmond, and we're doing it in Simi Valley, California. In Rancho Cucamonga, California, the city is our partner. The city has a piece of land that they want to do something with. So we took them to Temecula where we did something similar [with the city of Temecula] and they think we're great, so we're doing the same thing in Rancho Cucamonga. So in all these places, it was a situation where someone controlled the opportunity either by owning the land or by controlling the opportunity. In the case of the city, they needed a developer with a track record, experience and style.

PwC: As you think about your growth prospects and the strategic plan you're about to enter into for your next four year cycle, do you see yourself looking more toward the Prudentials, the AIGs, the GE Capitals of the world as opportunities for joint venture relationships, or do you have any expectations in that regard?

CR: We've had good experiences with those types of firms and we see that as a real possibility. As our balance sheet is larger and we have and want to do projects of larger scale, then the opportunity to joint venture with those kinds of people is terrific because those projects represent very large risks.

PwC: Tell us about your growth strategy.

CR: One of the things that uniquely characterizes Forest City is that we're a real estate developer. Our growth has largely come about through development of new product as opposed to acquisition of existing product. That's a very differentiated strategy today because the REITs by and large grow through acquisition.

We believe that we can add the most value by developing something from the ground up. Where does the real creativity come in the business? Where does the real value get added? It gets added when you find some raw piece of land somewhere and you say: "Gee, this would make a great X"—whatever that X is. It could be an old building that you can convert into something terrific, like we've done in Richmond with the tobacco warehouses, or like we did in Philadelphia with the old Drake Hotel or the old Bell Atlantic office building. Or like we did out at Lowry Air Force Base with an old air force barracks, or in downtown L.A. with the old subway terminal office building, which we are converting into residential. It can be that kind of thing. In one way, it's an acquisition because you're buying something. But basically it's a development because you're using historic tax credits; you're

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using tax increment financing to drive returns so that you can take what would be very expensive to convert and have it be market competitive. I just came back from Richmond, where we have taken these old tobacco warehouses that were vacant for 30 years. These were empty buildings sitting on the James River right downtown and we've converted them into the most remarkable loft apartments that I've ever seen.

So we're a developer—and there are a lot of risks that go with development and there is lots of capital you have to put in as the developer early in the game in which you make no current return. Our balance sheet has $600 million in projects under development. That's development and construction—both our equity and the debt. But it's a lot of money sitting on the balance sheet and we turn that into new product at the rate of 400 or 500 million dollars a year. And we think we get a premium return as opposed to competing with everybody else to buy some existing apartment building or retail center that people are paying very low cap rates to acquire because there's no real value added here. It's just a competitive market issue.

Our goal is not to be the biggest. We have no aspirations to be the biggest in any product or even in total. It's all about shareholder return. It's all about driving value. It's all about using technique to drive equity returns—and this ultimately becomes what the shareholder buys. And in that regard we've done well. So it's a development strategy—as distinct from acquisition—and it's a development strategy characterized by certain core markets and certain core products.

PwC: But you still do some acquisition?

CR: We do some acquisition. In fact, we have done a lot of acquisitions and residential is a good example. We will buy whenever we find that we can buy at a reasonable spread between our return on cost and our cost of capital. Today, we are buying things at a very low cap rate because we can finance at very low rates. We're doing that kind of thing. We just bought in Baltimore; and we're buying in Denver because we think we can buy at a 200-plus-basis-points-spread because we can finance so cheaply.

PwC A lot of other real estate companies are considering or already have opted for REIT status. Do you have any plans along that line?

CR: That brings up one other piece that differentiates Forest City—that's the idea of this capital structure, which is a very important part of how this thing works. I'm sure REITs are the right

structure for all those other people and some very smart people are still converting.

We believe two things characterize the capital structure as we have it, which makes it work best for a development company. One is the ability to use nonrecourse mortgage debt at higher levels than the REITs can use it in order to maintain the credit positioning that a REIT needs to have. Today, we are a non-investment-grade company—and we pay a premium over what REITs would pay for the same capital. But we're able to use 70-75 percent of value on a first mortgage debt, whereas they are able to use only 40-50 percent. When you do the capital model and you structure any real estate deal, just as you would do if you bought a home—you don't want to put all your money into it; you want to get a mortgage. You get the tax deduction and the interest; you get to use your capital to make a higher return. That's what we do, and we've done it that way for 50 years and we think it is the best way for us. We think it drives the highest equity returns.

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Now, with leverage comes risk. You could leverage something up to 100 percent and have an infinite return. So you have to have some governor or moderator in force. But the most important ingredient is that it is all nonrecourse debt. If our balance sheet were structured with recourse mortgage debt, it would be a terrible investment. But we don't have a single recourse mortgage out of almost $4 billion of mortgage debt. Nor is any mortgage cross-collateralized—that is, one building is not dependent on another building. So no asset can take this company down. And I would argue that this balance sheet is safer than the typical balance sheet, where there's a lot more corporate recourse debt on it. We only have, altogether today, $300 million of bonds and a $350 million line of credit that we used $200 million of—so we have $500 million of recourse debt on a five- or six-billion-dollar balance sheet. So it is very under-leveraged in terms of recourse.

Our capital strategy is designed around the belief that as a developer you need to retain the capital—you can't pay it out as a dividend. To retain it, you have to earn a better return on it than the guy who's getting a six or seven percent dividend. We think we can do that. We've got the track record that proves it in the end. So we retain the capital by paying a small dividend, we invest that capital in new development, we build the development with a nonrecourse construction loan, the development opens, we go out and finance the new property that's opened at 70-75 percent of value instead of cost—that enables us to take out almost all of the initial cash we invested, tax-free, which of course is the thing that's been driving real estate for 100 years, and you reinvest that in the next project. Then you keep recycling that capital. It's a differentiated strategy. It's old and it's not. It's not a creative strategy—the creative part is where we're able to use all different types of this kind of financing.

The project we did in Richmond at Tobacco Row is one of the most creative financings I've ever seen. We used historic tax credits; we used UDAG grants; we used public entitlement grants and loans; we used tax increment financing—all of these to drive down the cost of that debt and drive equity returns.

PwC: Of our client universe, Forest City seems to be one of the most disciplined with respect to its strategic plan and how you use that to drive your business and drive behavior among your senior people. Soon, you will be embarking on your third four-year plan—can you talk a little about your approach?

CR: We have built a business for more than 80 years with great success. But most of our success, I think, was driven by our board. We have some board members who have been fabulous assets for us, and have been since 1960. One of the members is Scott Cowen, formerly dean of the business school at Case Western Reserve University and is now the president of Tulane University. He suggested to us that strategic planning was a discipline that we needed to adopt as the company was beginning to grow dramatically.

Real estate is a deal-based business—there's no business every day; it's just a series of deals, right? We ran the business in that entrepreneurial fashion and we did so successfully. The company grew and started to accumulate a balance sheet of several billion dollars and wanted to grow. It was obvious that to do more projects of bigger size, we needed to have a plan. We had to have some strategy for how we wanted to allocate capital and how we wanted to grow and where. And we needed to compensate people more than just on the deals they did. We needed to start compensating people more on how much value they could add to the balance sheet for the shareholder. So we put in this process where we basically learned strategic planning from the start, with the most rudimentary exercises.

We did the SWOT analysis—what are our strengths, weaknesses? What are our opportunities and threats compared to the universe and the competition? Then we put together a mission statement and a series of core values that are very important here, with things like integrity and diversity and sustainability. They do drive behaviors. Integrity is the foundation of everyone here and everything we do. That's why we've been able to be in business for 80 years. That's why we've been able to do business with the same cities and the same partners for generations. Because as our partner in Richmond said recently, we deliver on our promises and we deliver beyond our promises.

So we went through this whole thing and then we started on the real estate strategies—a market strategy, a product strategy, a customer strategy, and we put them in place. We set one-year goals and four-year goals. Our single measure of success is value—we value the real estate at the beginning and we value it at the end. We have a target for how much we're supposed to increase that value. And if we hit it, we succeed and if we miss it, we fail. That same measurement has been in place for more than a decade and it's working well. It drives the right behaviors on the part of the leadership and executives. Everybody understands what the rules are and how we are measured.

So we have to build an asset that has real value to the community, and then it will have value to us and our partners. The truth about the real estate business is, once it gets to this size, the thing really runs on the numbers. I used to say that I could go out and see every asset and kick the tires and know every deal. The truth of the matter is I spend a great deal of my time focused on the numbers. We have an investment committee. Every project from the beginning has to have a pro forma. It has to have a plan. We have multiple measures of return, hurdle rates and all that kind of stuff. We have cost of capital models. Those are the key things—because the whole business is based on the spread between the cost of capital and the return on cost. The overriding strategy that we have learned is—if you invest in returns that are greater than the cost of capital, you will build shareholder value. If you invest in returns that are greater than the cost of capital, you will ensure shareholder value.

PwC: Given that your projects by and large have long lead times and that it takes a while to get a development up and running, what's your sense of where we stand on the economic cycle—how do you see things over the next one to three years?

CR: That's an interesting question. Tony Downs, at The Brookings Institution, told us early on in this process that in the real estate business, you can't be a market timer. He said that with our lead times, by the time we start, we can have no idea what the market will be like when we end. We've been both beneficiaries and victims of that. Whoever knew you could borrow money for our Richmond project at 5.6 percent? I can't even remember when a pro forma did that. The truth is, the return is less than we thought because of the competition and the economy, but the financing was less by a greater amount so the spread is higher than we thought.

You know the statistic that if you're out of the stock market for 30 months out of the last 30 years, your return is half of what it would have been if you had not tried to time the market, so you have to be in for the long haul. We believe that about real estate, particularly real estate development. In the acquisition market, you can try to play the market, but as a developer you basically have to be in there, and that's what we've tried to do.

You can't force the market in this business. You can't run a sale this week to run out the inventory. You have to respect the market, and if you can't make a return—if you can't lease something for an amount that will enable you to make this return over the cost of capital—then you better not build it. In the early 1990s, we went from $500 million under development to $50 million under development in less than 24 months because of the RTC and all the other stuff out there; you couldn't make a return.

> ***"You have to respect the market, and if you can't make a return—if you can't lease something for an amount that will enable you to make this return over the cost of capital—then you better not build it."***

We don't find that to be the case today, but we're still finding new opportunities. We believe that the economy is very soft—softer than anyone has acknowledged. Every indicator we have tells us that. Our comparable NOIs are still down, particularly in the residential apartment business—after 10 years of consistently growing. And we don't see any turnaround in that. We don't see any concessions coming off—in some markets, we have to use concessions in order to lease. We don't see any let-up in concessions in the office building business. So we don't see that improving for the balance of this year—and frankly we think it's going to be 2005 before there is any real recovery. Real estate is likely to be a lagging indicator and we still see it as being tough for some time to come.

That said, real estate requires a long-term outlook, and we operate with a long-term perspective and commitment. We believe and invest in this business and develop new properties so that we can continue to create value for our shareholders. ❖