MACK-CALI Anatomy of a Merger

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Critics wondered how Cali Realty could sustain its three-year feverish growth rate. The firm's $1.2-billion merger with the Mack Co. answered their questions.

The merger of Cali Realty Corp. and the Mack Co. in December her created a real estate investment trust with extraordinary financial clout and an immediate presence in several growing suburban office markets. But the marriage has done much more. The combined firms today stand on the threshold of major new market inroads.

In many respects, the $1.2-billion merger of Cranford, NJ-based Cali and Roehelle Park, N.J.-based Mack is the culmination of a period of intensive growth for Cali. The firm's first three years as a REIT — it went public in August of 1994 — produced a cumulative return of 178%, leading real-estate-shy banks to extend the company a $400-million unsecured line of credit in late August. Those returns, not surprisingly. also created enthusiasm on Wall Street when Cali sold 13 million shares to raise another $491 million in October.

But this success led many real estate professionals to question how the company could maintain its feverish growth pace, especially with available space in its core market drying up and little new space coming on line. The marriage to Mack, a family-owned developer founded in 1896, is likely to provide the answer.

As a result of the deal, Mack-Cali Realty Corp. has grown from 13 properties totaling 2.2 million square feet to 21.6 million feet of office, flex and industrial space in 187 buildings in 10 states. The merger created a company with a presence in Phoenix, Houston, Dallas and San Antonio, as well as a 270,500-square-foot office building in San Francisco and a 285,000-square-foot office asset in Tampa. It also broadened the company's access to tenants in growing industries, including energy, financial services and telecommunications.

And in terms of its core market — the office segment of northern New Jersey, the sixth largest office market in America — the firm now owns 8% of all the office space in that region and 20% of the market's class A space. The firm also owns some 200 acres of undeveloped land.

Core-Market Focus

Mack-Cali's new leadership—CEO Thomas A. Rizk, president and COO Mitchell Hersh, chairman John J. Cali and executive committee chairman William L. Mack, the group responsible for the firm's strategic direction — say they do not plan to become a national REIT. Their near-term focus is on their core Northeast markets and building on their significant presence in the Southwest.

But given the firm's capital access and its development expertise, many see those goals as modest. As PaineWebber analyst Paul Adornato put it in an October research report: "The addition of Mack senior management should allow Mack-Cali to compete more effectively with the largest and most sophisticated public real estate companies."

The merger follows a philosophy Cali has pursued throughout its young public life, says Mr. Rizk, who previously served as president and CEO of Cali. "If you compare us to other significant companies in the

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industry, you'll find one or two important differences," he says. "Our philosophy has been to focus on markets where we can be in a majority position with the best assets, then put together the best management teams made up of the guys who have been on the ground and have been the most successful."

The Cali family business was started in 1949 by Mr. Cali his brother Angelo and Edward Leshowitz. John Cali's son, Brant B., and Angelo's son, John B., later joined the company and became chief operating officer and chief administrative officer, respectively.

"We started in the residential market and built a lot of housing, including condos and apartments," John J. recalls. "All of them in New Jersey. In the late 1960s, the market demographics turned and some opportunities came our way in suburban office development. When we decided to enter the office-building business, we made a couple of basic assumptions: We would provide attractive places for people to work and seek properties with multiple tenants."

The strategy paid off as Cali built a tenant base with such names as Bankers Trust Co., Dow Jones and AT&T, Cali's largest tenant. The organization survived New Jersey's office market bust in the last recession by holding onto cash. "We had the same problem as any developer," Mr. Cali says. "We came through the bad times very well because we saved our money. We did not distribute any cash flows. So we had the money to pay for tenant improvements and that kept our offices filled."

Mr. Cali, now 79, also wanted to make sure he did not leave an estate that would be overburdened with taxes. "Our offices were doing well, but we weren't making a lot of money," he says. "There were people who wanted to buy our properties. But to sell them and pay the recapture taxes would have been a very tough thing to do."

Meanwhile. Mr. Rizk, whose work as a real estate and tax attorney helped him develop expertise in finance and the capital markets, had begun trying to find an underwriter to help take Cali public. He had watched with admiration as Cali Realty went public in 1993.

"But there was an obstacle," he says. "People thought the Cali deal was successful because it was based in Washington, D.C., and that's a very sexy market. New Jersey was one of the largest office markets in the country and it was one of the best-kept secrets."

It took Mr. Rizk a year to convince Prudential Securities to lead an underwriting team, for which the underwriter signed on Smith Barney and PaineWebber as co-managers, even though Cali had assets of about $300 million and equity of $200 million.

After the transaction was completed, the firm began acquiring office properties from suburban Philadelphia to Fairfield County, Conn. The 1.9-million-square-foot Harborside Financial Center, on the Hudson River in Jersey City, was one of its most notable acquisitions. Harborside, purchased in the fall of 1996, increased the portfolio by 40% and was followed a few months later by the announcement of a $440-million merger agreement with the Robert Martin Co., based in Elmsford, N.Y.

Robert Martin was the dominant owner in its core areas, which covered Westchester County's 32-million-square-foot office market and Fairfield County, which has 37

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million feet of office inventory. Robert Martin's holdings included the 1.4-million-square-foot Cross Westchester Executive Park in Elmsford and the 670,000-square-foot South Westchester Executive Park in Yonkers. Its 600 tenants included Bank of America, Eastman Kodak, McGraw Hill and Time Warner. For the Robert Martin merger, Cali paid $211 million in cash, assumed $185 million in debt and issued $44 million worth of operating partnership units. It also increased the Cali portfolio to 11.3 million feet of class A space.

Development Buzz Begins

With the purchase of Harborside, in a market that has been running a class A vacancy rate near zero, Cali acquired 11.3 acres of fully zoned property that has permits for 4.1 million square feet of development, as well as the development and water rights to another 27.4 acres, including two piers. A space-hungry market began to buzz with talk of Cali becoming a developer again.

The company has since announced plans to build the American Financial Exchange in a tract of land it owns near Harborside. Cali followed its fall 1996 Harborside purchase and the January '97 Robert Martin buy with a string of asset acquisitions throughout the year. They are:

- On July 24, the firm purchased vacant class A office buildings in Moorestown, N.J. Cali paid Metropolitan Life Insurance Co. $10.2 million for the two, 75,000-square-foot buildings, the only available large blocks of space in the area. They are located in the Moorsetown Corporate Center.

- On August 4, Cali announced its $15.5-million acquisition of Shelton Place. a 133,000-square-foot office building in Shelton, Conn. The property, with 11 tenants and a 97% occupancy, increased Calis Connecticut holdings to four buildings and a total of 300,000 square feet.

- On August 18, Cali exercised a purchase option it obtained in the Robert Martin merger and acquired another South Westchester Executive Park property for $8 million. The 84,000-square-foot office/flex building, which was .98% occupied by seven tenants, increased Cali's Westchester County holdings to 63 properties and more than four million feet.

- Three weeks later, on September 4, Cali acquired a 111,000-square-foot class A building at Three Independence Way in the Princeton (N.J.) Corporate Center. The price was $13.1 million.

Although plans for the American Financial Exchange are still in the early stages, Mack-Cali executives are talking about development as a part of its future growth. Institutional investors and lenders have started to come around to accept the idea of REIT's as developers, Mr. Rizk says.

A Change of Heart

"Many institutional investors did not want to see this type of vehicle become a developer, even though most of the people involved had been developers," he explains. "We have been developing for 45 years. Today, the attitude is beginning to change. As prices get higher, development becomes an important part of the story, the theory being that returns on the development end are higher than on an acquisition."

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The Mack-Cali merger was a logical next step in the strategy to develop a strong capital position that would open new doors for the company and allow it to be even more nimble in pursuing its entrepreneurial goals. The Cali and Mack families had been friendly competitors for decades. "William Mack has the same history as we have." says Mr. Cali. "I knew exactly what Bill was building every year and he knew the same about us."

Or, as Mr. Mack, who had discussed with his brothers the possibility of taking the family business public for several years, puts it: "This was the right execution at the right time with the right company. Cali was a natural partner."

Especially since bonds were developing in the next generation of Cali and Mack executives. In fact, Mr. Rizk and Mitchell Hersh, chief operating officer for Mack, were neighbors in Passaic County. N.J. and had become friends, a fact both men say helped allow a seamless merger.

"The driving force was the ability to create a vehicle with a substantial balance sheet and have the opportunity to do things we couldn't do in the past," Mr. Rizk says. "Today, we have a total of $3.4 billion in capitalization and about $1 billion in debt. So you're talking about $2.4 billion in equity, and that's a substantial balance sheet. We probably have the ability to move our line of credit to about $1 billion."

"It really opens up opportunities we didn't have before," he continues. "We can do larger transactions. We can be both a money partner and an active investor. And we can close transactions more quickly. Look at the Mack transaction. We closed just a few months after it was announced. Some people can't close on a house in that time."

Barry Lefkowitz, who is CFO, says being able to make acquisitions and complete large transactions without disruption to ongoing operations will continue to be an essential part of maintaining the company's pace of growth. "One of the things we pride ourselves on is that, before we do a transaction, all the systems are merged," Mr. Lefkowitz says. "When we did the Robert Martin transaction, for instance, we required that they he operating on our computer system the day we closed. That's unusual in any merger. We came to terms with them on a Monday and closed the deal on Friday. The same thing with the Mack deal: we required that they he up and running on our system. As a result, the experience tenants are going to have in Cranford is the same they will have in Westchester and in Texas. We're very focused on providing a uniformity of quality."

Purchase of a Pioneer

With the acquisition of the Mack Co., Cali also gains an entrepreneurial spirit, and Mr. Rizk praises the firm's role as a "pioneer in a couple of areas."

In the late 1960s, Mack started developing warehouse and light-manufacturing facilities in North Bergen and Secaucus. N.J. It had developed more than 12 million square feet by 1975. when the company turned its attention to suburban office development. The principals — brothers William, David, Earle and Fred Mack, along with Mitchell Hersh, built the 330,000-square-foot Mack Center II in Paramus, N.J., one of the first substantial office developments in the suburbs.

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"We grew through various types of development," says Mr. Hersh. "We built strictly for our own account and amassed a portfolio throughout New Jersey, with a few properties in suburban Philadelphia, that included six million square feet of class A office space."

Also, beyond his role as senior managing partner at Mack, William Mack also co-founded Apollo Real Estate Management in April 1993 and has since served as its president. Apollo has raised about $2 billion in equity in its three real estate funds and invested in properties worth about $8 billion and other real estate assets totaling about $15 billion. The funds' investments include properties in Western Europe as well as both public and private operating companies at home.

In 1991, the Mack Co., along with entrepreneur Paul Nussbaum, became the first to make a bulk acquisition from the Resolution Trust Corp. when it purchased office properties and formed the Dallas-based Patriot American Group. Mack bifurcated the company, spinning off Patriot Americans hotel holdings in a deal with partner and co-founder Mr. Nussbaum, who now serves as chairman of Patriot American Hospitality Inc., a lodging REIT.

When Mack acquired the Patriot portfolio, it was approximately 50% rented. "But when you looked at it carefully, it was actually 35% rented because a lot of the tenants were on a month-to-month basis or had temporary leases," Mr. Mack says. At the time of the merger. 91% of the space in the Southwestern properties was leased.

"We think we've done some very interesting and creative things in creating acquisition and development structures." says Mr. Hersh, who is an architect. "So, in the context of public markets, we can bring that expertise up front and raise the bar, so to speak, on what this company can do."

Wall Street Is Listening

The performance of both companies, and the potential of their merger, has impressed Wall Street. Wheat First Butcher Singer, one of the growing number of investment companies that has issued buy recommendations on Cali stock (CLI on the New York Stock Exchange), forecast sustainable three-to-five-year growth with the merger at an annual rate from 13 to 14%. And PaineWebber reports that Cali's conservative accounting policy of not including straight—lined rents in its FFO calculations results in a lower reported FFO. This means that Cali's stock has been trading at a 5.4% discount to its office-REIT peers.

"We have seen clear evidence that, on the retail side of the house, REITs have become much more popular and, with Mack going public, we are beginning to see more institutional interest," Mr. Hersh says.

This, of course, is not surprising, given the watershed nature of the industry's growth. "This industry is moving away from financing itself as a collection of assets and moving toward financing itself as a business that happens to be in real estate," says CFO Lefkowitz. "This is a very exciting time for REITs. In this country, less then 10% of the commercial real estate is owned by REITs or other public real estate companies. The other ownership is institutional and it's generational, often with large family holdings. We're starting to see the transformation from private ownership into a secruitized format.

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Insurance companies and institutions are starting to divest themselves of their property — and that gives us a tremendous opportunity. We're sort of in the infancy of this."

But growth for the infant will be measured. Rather than pulling out all stops to become a national REIT, Mack-Cali will focus on becoming a so-called super-regional. Company executives say it will continue to pursue properties in suburban markets and is less likely to enter large urban centers like New York City, where gaining a dominant position is made more difficult by the vast size of the marketplace.

"What you will not see us do is go into new markets and simply buy the assets," Mr. Rizk says. "Other companies have been successful pursuing that strategy. However, that isn't our strategy. We improve our chances of succeeding by joining up with management teams that have been most successful in markets we want to be in. To some degree, we're a hybrid. The important thing is that we have the infrastructure and the right amount of the best assets in a particular market."

With that approach in mind, says Mr. Hersh, Mack-Cali probably will sell several one-off properties that the Mack Co. owned in Des Moines and in Omaha.

Targeting Opportunities

"Our goal," says Mr. Rizk, "is to improve performance, not just keep it up." It is a significant goal. As 1997 neared an end, Cali's returns appeared to be increasing by the 50% level the company achieved in the two previous sears, Mr. Lefkowitz reports.

Looking ahead, the new company expects to see a significant part of its growth in the markets opened up by the merger. "In my opinion, in addition to our core market, the Southeast and Southwest offer great opportunities, as does the West Coast," says John J. Cali.

Mack-Cali's four Arizona properties total more than 484,000 square feet. "In general, our properties are all suburban office buildings and in Arizona they are part of campus developments," he continues. "Our tenants include American Express Travel-Related Services, which has consolidated in the Phoenix area. We also did a built-to-suit for Honeywell's R&D division."

Mack-Cali also owns 17 properties, totaling 2.5 million feet, in Texas, including 862,000 square feet in Dallas, 700,000 square feet in Houston and 692,000 square feet in San Antonio. The Dallas properties include Tri West Plaza, a 365.000-square-foot, 17-story office tower in the north end of the city, a section where growth is being driven by the financial services and energy industries. In Houston. where NASA and the Texas Medical Center are important employers. Mack-Cali's properties include Katy Plaza, a six-story, 112,000-square-foot asset. The company also owns two buildings at St. James Place with of total of 174,000 square feet of office space.

William Mack sees all of the markets in which the new company has a significant presence getting stronger at a time when Mack-Cali will he negotiating numerous lease renewals. "Westchester is earlier in its recovery than the rest of Metropolitan New York." he says. "but it is coming on strong. New Jersey is strengthening on a daily basis, and its rents are going up. The suburban Philadelphia

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market is also strengthening. The Southwest is improving and, since we leased much of our space in that market in the early 1990s, we should expect substantial rent increases as leases turn over."

The new company also has big plans for its core market in northern New Jersey. "While we still do not see a rash of spec development anytime in the near future," says Brant Cali, "we do see several markets tightening." He adds that class A office buildings along the Jersey City waterfront are 97% occupied. "The next phase of our master plan for Harborside will be Harborside IV. We also plan to build the American Financial Exchange nearby."

At 600 feet and 42 stories high. American Financial Exchange will be New Jersey's tallest building. Work is underway to reinforce the bulwarks that will support the tower, although no anchor tenant had been announced as of mid-December.

Mark Ravesloot, senior director of Jones Lang Wootton USA, Harborside Financial's leasing agent, says only about 26,000 square feet of space in Harborside I, II and III was vacant or had the potential of becoming vacant as the year ended. Four tenants — Bankers Trust, Dow Jones Telerate, the American Institute of Certified Public Accountants and the Dean Witter Trust Co.— now occupy 65% of the three-building asset.

"We're really focusing all of our efforts right now on new development." Mr. Ravesloot says. "We are working with architect Cohen Peterson Fox to work up a new master plan for future development in four smaller buildings. We're finding strong demand from tenants in the 100,000-to-200.000 square-foot range. So we've broken it down to buildings that can range from 600,000 square feet to 1.5 million."

The American Financial Exchange, which would he just to the north of Harborside, is being planned with a parking site and ferry dock. It could add as much as 1.3 million square feet of office space to the Mack-Cali portfolio in one of the company's hottest markets, its own backyard.

Source: Real Estate Forum