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THE WORLD'S GREATEST REAL ESTATE INVESTOR

(and what you can learn from him)

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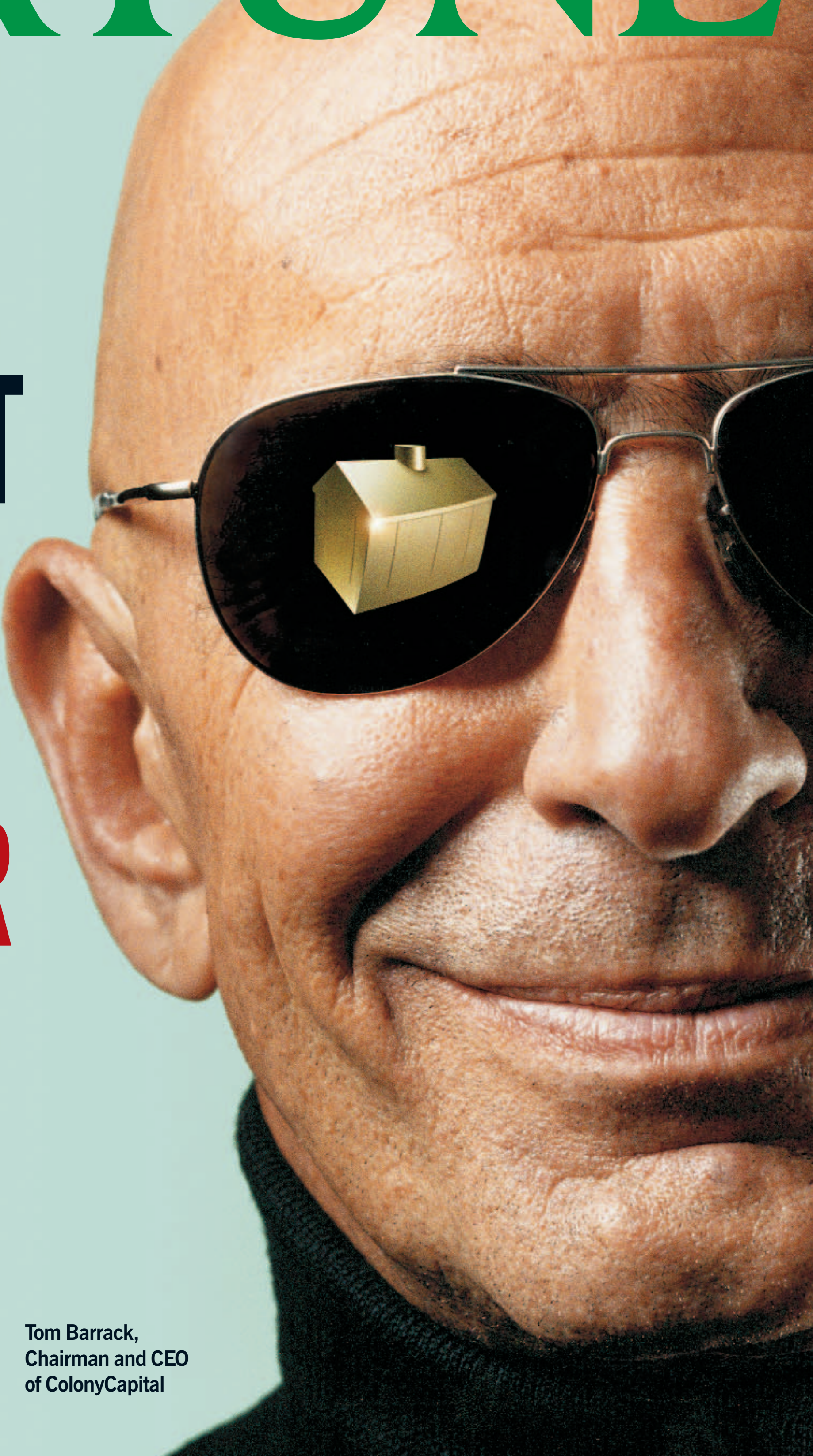

Tom Barrack, Chairman and CEO of ColonyCapital

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I'm Tom Barrack* and I'm getting out

*The world's best real estate investor has made billions in the U.S. market. Now he's cashing out and buying overseas. Should you cash out too? By Shawn Tully

Tom Barrack is driving a dusty Chevy Suburban around his 1,200-acre mountain ranch near Santa Barbara, Calif. Nestled between the Ronald Reagan estate and Michael Jackson's Neverland, Barrack's spread is a medley of vineyards, pastures, and paddocks. Barrack cruises past the lovingly restored manor house, a rambling adobe aerie framed by allées of cabernet franc, then weaves through a cluster of stables sheltering 60 horses that munch homegrown wild oats. Even in this magical setting, real estate is never far from his thoughts. He stops the Suburban at his favorite spot, a vast polo field planted with delicate, lime-hued Bermuda grass that's easy on the horses' hooves. Then Barrack launches into a parable. "I feel totally safe playing polo on a field full of pros," says the bronzed 58-year-old. "But when amateurs are all over the field, someone can get killed. They have more guts than brains. They charge after every ball and don't know when to hold back." It's the same with the U.S. real estate market right now: "There's too much money chasing too few good deals, with too much debt and too few brains." The amateurs are going to get trampled, he explains, taking seasoned horsemen, who should get off the turf, down with them. Says Barrack: "That's why I'm getting out."

Investors, take heed. Barrack may be an amateur in polo, but when it comes to judging markets, he's the ultimate pro. Arguably the best real estate investor on the planet today, he runs a $25 billion portfolio of trophy assets, from the Raffles hotel chain in Asia to the Aga Khan's former resort in Sardinia to Resorts International, the largest private gaming company in the U.S. Barrack's Colony Capital of Los Angeles, one of the largest private-equity firms devoted solely to real estate, has racked up returns of 21% annually since 1990, handing investors, chiefly pension funds and college endowments, 17% after all fees. Barrack has done deals with Saudi princes, Texas oilmen, a Caribbean dictator—even with Donald Trump. He bought the Fukuoka Dome, Japan's Yankee Stadium, in part because he calculated that the titanium in the retractable roof was worth as much as the purchase price. He bought and sold New York City's Plaza hotel, turning a fast $160 million profit, as well as London's tony Savoy chain, netting another $270 million. Even Trump defers: "Tom has an amazing vision of the future, an ability to see what's going to happen that no one else can match."

In the clubby world of bigtime real estate investors, Barrack is a star; outside that circle few people have heard of him, in part because he's never run a publicly traded company. But that doesn't diminish his accomplishments or his insights. Worth more than $1 billion—a fortune amassed over four decades of dealmaking around the globe—Barrack is the quintessential insider. After much cajoling, he agreed to speak with FORTUNE about a wide range of issues: the year he spent as assistant secretary of the interior in the Reagan administration under James Watt, an infamous foe of environmentalists ("Watt would talk about mining the parks," recalls Barrack. "I wanted to climb under the table"); a favor he did for Edwin Meese that brought him into the cross hairs of a special prosecutor ("I've always been under the radar screen, so I hated the notoriety," he says now); his contrarian investment philosophy; and his dark fears for the U.S. real estate market.

> "There's too much money chasing too few good deals with … **too few brains."**

Barrack is a man of immense charm, a swashbuckler who moves at a furious gallop yet exudes an aura of calm. At 6-foot-3, he has the lanky build of a wide receiver—and the velocity: He's constantly circling the globe in his Gulfstream IV. "He goes crazy if he has to stay in the same place three nights in a row," says Mark Hedstrom, Colony's CFO. In the summer Barrack ostensibly lives in Sardinia, but he jets off every few days to New York, London, or Tokyo and spends weekends with his family in the South of France at a medieval chateau, once summer home to the bishop of Grasse. (Barrack has a 9-year-old son plus three adult children from a previous marriage.) He sleeps no more than four hours a night and doesn't wear a watch. "In his world there is no day and no night," says Tom Harrison, a chief lieutenant. "He acknowledges no changes in time zone. His time is totally fluid." For relaxation he plays polo at tournaments in California—his teammates are three Argentine professionals he's hired—or surfs in Hawaii with a free-spirited bunch of fiftysomething locals who've dubbed themselves the Beach Boys.

His approach to investing is as strikingly original as the man himself. Most celebrated real estate operators these days are in the real estate investment trust (REIT) business—Sam Zell at Equity Office Properties and Equity Residential Properties, Steve Roth at Vornado—but they tend to focus on buildings with strong tenants that can reliably deliver annual returns of 7% or 8%. Barrack shuns what's known in the trade as "chasing yield." He's aiming for returns double or triple that size. To get his gaudy numbers, he'll go to the far corners of the globe, looking for underappreciated assets he can buy cheap, fix up, and resell, usually within about five years. If a potential deal is complicated or politically sensitive, so much the better. Barrack cherishes thorny situations because they scare off most other bidders. Auctions aren't for him. "How do you congratulate yourself when you've outbid eight of the smartest people in the world?" he marvels.

There is much method to his madness. By focusing on distressed properties with lower pricetags, he limits his risk and maximizes his potential gains. He has 182 employees around the world who monitor local markets, looking for opportunities he can exploit. At the same time, he buys primarily high-quality properties—those that, if skillfully resurrected, can command a premium. London's Savoy is a case in point: Controlled for 40 years by a family trust when Barrack's Colony and private-equity firm Blackstone Group scooped it up in 1998 for $950 million, the chain had failed to promote itself to U.S. business travelers. Barrack and Blackstone did, and in mid-2004 sold it for $1.4 billion, having already pocketed $100 million from such gambits as converting hotel rooms into luxury condos at the legendary Connaught in London.

A different sort of example: his U.S. casino properties. Colony bought

Watching the bubble detectives

TOM BARRACK IS HARDLY the only investment pro anxious about the U.S. housing market. Federal Reserve chairman Alan Greenspan has expressed concerns, as have many Wall Street prognosticators who scan key stats like housing starts for signs of trouble. Pimco, the big California bond specialist, isn't sitting around waiting for official numbers; it's digging up its own. "We felt that [a housing slowdown] was going to have a major, economywide impact," says mortgage chief Scott Simon, who is predicting that the overall residential market will cool noticeably next year. "Being able to tell when it occurred was really important."

For that task Simon is employing old-fashioned shoe leather. Last spring he assembled a group of analysts called the Housing Investigative Team and dispersed them to grill homebuilders, real estate agents, loan officers, and appraisers in cities across the country. So far, Team Pimco has visited 20 metro areas—including San Diego, Las Vegas, and Chicago—to collect data on everything from exotic mortgages to the number of days homes sit on the market to the percentage of buyers who are investors. Team members reinterview their sources every month to see if anything has changed.

Simon's findings? "We think that San Diego will be the first place that turns down in any meaningful way," he says. One big clue: a mind-boggling 50% of San Diego's borrowers use non-conventional mortgages (a sign that people are buying more house than they can afford), compared with 20% nationally. Another yellow flag: In certain neighborhoods homes priced at more than $650,000 aren't attracting the homebuying hordes. He predicts that Miami (too many investors) and Washington, D.C. (too many condos), are also in line for a reality check.

For competitive reasons Simon wouldn't dole out much more information. But he had second thoughts about his own backyard during a fact-finding mission to Dallas this summer. He visited a 3,000-square-foot home with a beautiful kitchen, three bedrooms, exquisite landscaping, and a pool. Price: $300,000. Price in Orange County, where Simon resides: $2.4 million, give or take a hundred grand. "I couldn't believe how cheap it was," he says. "It gives you a much better appreciation for where the problems are."

— Ellen Florian Kratz

the Resorts casino in Atlantic City in 2001 for $140 million, about half what its previous owner had paid five years before. Then Caesars decided to sell the Las Vegas Hilton in 2003—but didn't want to turn it over to a big rival like MGM Mirage. Barrack swept in, already equipped with a gaming license, and grabbed it for a bargain $280 million, one-tenth of what Steve Wynn would spend to build his new casino, which is roughly the same size, around 3,000 rooms. Barrack and his casino operations chief, Nicholas Ribis (who'd kept Trump's gaming business afloat in a sea of debt in the 1990s), repositioned the Hilton away from high rollers and toward visitors flocking to the neighboring Las Vegas Convention Center. Even with its $135-a-night rates, the Hilton now generates $36 million in annual cash flow, five times the figure when Colony bought it. All told, Barrack's six casinos produce $2 billion in annual revenue and $120 million in after-tax profits on an equity investment of $540 million—a 22% return.

> "Tom," says pal Donald Trump, has **"amazing vision** ... no one else can match."

LIVING ON THE EDGE

IF BARRACK'S LIFE story offers a lesson for ordinary investors, it's that you should always operate in areas where you have an edge. It's a theme that comes up again and again over the course of Barrack's career.

The grandson of Lebanese immigrants, Barrack grew up in the Los Angeles suburbs in a tiny stucco house, where his mother hung out the wash. His father worked 18 hours a day at the family grocery store. After school Tom stamped prices on cans and manned the register. He went on to the University of Southern California, where he was a star on a national-championship rugby team, worked on campaigns for California Republicans, and in 1972 got a law degree. His first job was at the firm of Herb Kalmbach, President Nixon's personal attorney, but he didn't stay long. One of the firm's biggest clients, construction giant Fluor Corp., needed a volunteer to live in Saudi Arabia for a few months to negotiate a contract. Saudi Arabia was hardly a posh posting, but with oil dollars rolling in, it was deal central. Barrack leaped at the chance.

He found himself sleeping on a filthy cot in a Riyadh dormitory without indoor plumbing. But he soon learned that an American lawyer who could connect swaggering Texas contractors with berobed Saudi sheikhs could be a hot commodity. When his Fluor assignment ended, Barrack stayed on and went to work reviewing deals for two young Saudi princes. (Foreign suitors needed a sponsor in the royal family to win government contracts.) Barrack learned Arabic and immersed himself in the local folkways. "When I'd go back to California for a visit, my friends couldn't understand what I was doing," he recalls. But he knew: By going down the road less traveled, he was positioning himself to jump ahead. And jump he did. Barrack became a powerful middleman, and over 4½ years did tens of millions in deals for the princes, who collected rich commissions. Barrack himself made just $200,000 during his stint in the desert kingdom. "It was indentured servitude," he jokes. "A great education, and highly unprofitable."

But the education was priceless. In 1976, Barrack got a desperate call from Lonnie Dunn, a Texan who had bought a vast plantation in Haiti. Dunn planned to build a giant refinery there, but oil prices had jumped, putting his deal in peril. His one way out: Saudi Arabia was willing to sell its crude at a deep discount to certain poor countries—but at the time, Saudi Arabia had no contact at all with Haiti. That's where Barrack came in. Barrack's princes said they could arrange to have the kingdom grant the discount to Haiti; all they needed was for Haiti to reciprocate by extending diplomatic relations and most-favored-nation status to Saudi Arabia.

So Barrack and Dunn journeyed with the two princes to Haiti, where they had arranged an audience with Jean-Claude "Baby Doc" Duvalier, the Haitian dictator who'd taken over from his notorious father in 1971. At the palace, where the rotund Baby Doc perched on a throne, Barrack pitched the virtues of the deal. In the middle of his appeal, Baby Doc interrupted. "Can I try on the watch?" he asked, referring to a diamond-studded, $200,000 Piaget timepiece one of the princes was wearing. The prince agreed. When Barrack wrapped up, Duvalier had another question: "Can I keep the watch?" Baby Doc got the Piaget and opened the door for Saudi oil to come to Haiti. Dunn soon sold the land to the princes, who flipped it a few months later for an $8 million profit.

LAND OF OPPORTUNITY

THE SAUDI ADVENTURE was the first in a series of crafty career moves. Barrack returned to the States in 1976, when Dunn hired him to run his California-based company, a large builder of industrial and office parks. Barrack learned all about reading blueprints, parsing construction costs for office vs. warehouse space, and calculating what price per square foot to pay for land. When Dunn sold the company in 1980, Barrack stayed to run it for two years. After his unhappy stint with Watt in D.C. and a brief run as an investment banker, he was recruited by billionaire Bob Bass to work on real estate deals. A classic Barrack moment came on Oct. 19, 1987, the infamous Black Monday, when the stock market crashed. Barrack and David Bonderman, a Bass recruit who would become Barrack's partner on many deals, had been planning a

Barrack's big bets

Here's a rundown of some of the mogul's latest moves around the globe.

Getting out of:

Most U.S. real estate

■ **Condos in Los Angeles.** Just completed converting a rental building—the Azzurra in Marina del Rey

■ **Houses in Indian Wells, Calif.**
Golf-course homes at Toscana Country Club

■ **Condos in Miami.** Converted the Mayfair Hotel in Coconut Grove **Why?** Barrack thinks fevered speculation has overheated prices in the U.S., so he's getting top dollar for condos while he can. Sky-high construction costs, he says, will soon result in busted deals and, eventually, lower prices.

Getting into:

Asia, Europe, and one play in the U.S.

■ **Hotels in Asia.** Just bought the prestigious Raffles chain

■ **Sports complexes in Japan.** Fukuoka Hawks Town, including a stadium and a Cesar Pelli hotel

■ **The Accor hotel chain,** owner of Sofitel and Novotel chains. Bought $1.3 billion stake when European hotel prices were scraping bottom

■ **U.S. Casinos.** Buying down-at-the-heels properties on the cheap. Examples: Las Vegas Hilton, Resorts Atlantic City **Why?** Asia: Low prices, low labor costs, and rapid growth. Europe: Best deals reserved for the well connected; Barrack joins the club. The U.S.: He has an edge in casinos—he's licensed, and his usual rivals are locked out.

bid for the Westin hotel chain owned by Allegis. In that day's trading, Allegis stock fell 30%. Though Westin bids weren't due for a week, Barrack offered a one-day-only price of $1.3 billion. If the board fiddled, he warned, the offer would drop by $25 million a day. Desperate to secure a decent price amid the market meltdown, Allegis said yes. Barrack and Bonderman passed off most of the hotels to their Japanese partners. But they kept the Plaza for the Bass group at a cost of $250 million, and they quickly flipped it to Trump for $410 million.

The only speed bump during this period: When Congress began holding confirmation hearings on Edwin Meese's nomination as Attorney General in 1984, a House committee discovered that Barrack had helped Meese escape from a financial jam 18 months earlier, just weeks before Barrack was named to his Interior post. He had arranged to have a former employee of his buy Meese's house, using $70,000 that Barrack loaned him and later forgave. For a few months Barrack suffered a barrage of embarrassing publicity. The flap faded when a special prosecutor found no evidence that Meese had helped get Barrack the Interior job in exchange for the favor, and Meese was confirmed.

MINING THE S&L BUST

BARRACK'S BIGGEST payday was around the corner. In the late 1980s he'd arranged for Bass to buy a portfolio of bad loans from American Savings, a failing thrift that the federal government had taken over. Bass paid about $1 billion, less than half the face value of the construction notes, mortgages on office buildings, and other troubled credits. Bass and Barrack were able to turn around and sell many of the loans back to the original borrowers at 70 cents or 80 cents on the dollar, earning about $400 million. It was only the beginning of the S&L bust, and Barrack knew the opportunities would be huge. "He kept saying to me, 'The government will have to take over all these loans,'" recalls Bill Rogers, then one of Bass's partners. "He said we needed to be raising money to get ready for an incredible buying opportunity." Barrack formed Colony Capital, the first vulture fund for S&L debt, in 1990. With help from Rogers, who joined Colony, he pulled in money from Bass and GE Capital and later raised more from insurance king Eli Broad, Merrill Lynch, and the Koo family, the Rockefellers of Taiwan.

His timing was perfect. The newly formed Resolution Trust Corp. was desperate to dispose of $350 billion in nonperforming loans, most secured by real estate. Barrack was poised to write a check in 1991 forking over $1 billion for the first major loan package the RTC disbursed. Over the next four years he bought package after package. It turned out even better than American Savings had. Owners who were eager to keep their properties bought back their debt for 70 cents or so on the dollar. Any loans Barrack couldn't unload he bundled together and sold on the public markets as mortgage-backed securities. As the real estate market recovered, newly formed REITs also devoured his office buildings and shopping centers. By 1995, Barrack had reaped a profit of $2.5 billion.

Barrack rolled on, picking up bargains from Japanese investors who had overpaid for prestige U.S. properties, and feasting on bad debt in South Korea, Japan, and Taiwan after the 1997 Asian currency crisis. When the tech boom set in, he heard complaints from some investors. "Tech is giving 70% returns, and I'm getting 20%," Barrack recalls. "Suddenly real estate became Jurassic Park." But he never did more than dabble in tech. In 2000 he formed an investment company with Global Crossing founder Gary Winnick to do leveraged buyouts of tech and telecom companies, but the partners split after six months. Barrack ended up losing a modest $20 million on tech deals, including a stake in ill-fated Verado, a manager of data centers that went under in 2002. Through a spokesperson, Winnick says that he still invests in Barrack's funds and considers his former partner a visionary.

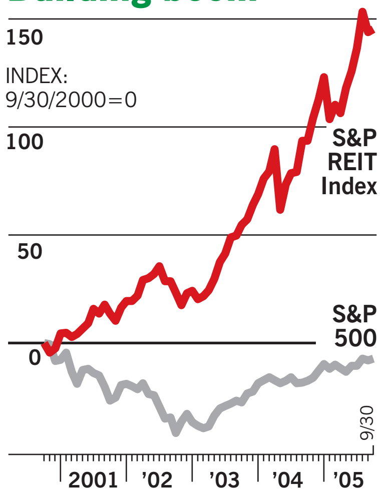
Time to sell real estate stocks?

IF BARRACK is right that the U.S. real estate market is on the brink of a bust, what do you do if you're knee-deep in homebuilding stocks? Or even real estate investment trusts (REITs)?

Let's start with REITs, where the outlook is generally good. The vast majority of REITs are focused on the commercial sector, which hasn't been as frothy as the housing market. If you invest in REITs through a mutual fund, as most folks do, you probably own a variety of commercial issues, from hotels to retail stores to offices. With forecasters predicting that the economy will continue growing at a 3% to 4% clip, the demand for these types of income-producing properties should remain solid.

Fund pros are particularly upbeat about hotel REITs. Star fund manager Ken Heebner has sunk more than 30% of his CGM Realty into the sector. His thinking: Hotel values are getting a boost from increased business travel. And developers in large cities are frenetically converting hotels into condos, creating a room shortage. You might also look for REIT funds that invest in Europe, a market Barrack still likes. One to consider: Alpine International Real Estate (EGLRX).

Building boom



Now for the troublesome topic: homebuilding stocks. We've been optimistic. (See "Hang on to the Homebuilders" on fortune.com.) But while Barrack is most worried about condos, his doomsday scenario would have a knock-on effect on homebuilders. And there are already signs of a slowdown. Homes are on the market longer in some areas, and mortgage rates are rising. On the other hand, studies show that people buy houses as long as the 30-year mortgage rate—currently 6%—stays below 8%. Population growth, fueled in part by immigration, is boosting demand for new homes. Plus, environmental and zoning regulations are tightening the supply of land. Those trends are intact. Finally, homebuilding stocks remain cheap. As a group, they trade for just eight times the previous 12 months' earnings. That's about 25% below their average P/E of 11 during the past 20 years.

With this much uncertainty, playing it safe seems smart. We wouldn't put more money into housing stocks just now. And for investors who have loaded up on the builders, this might be a good time to take some profits. — **David Stires**

THE BEST—AND WORST—MARKETS

TODAY BARRACK sees signs of the tech bubble mentality in the U.S. real estate market. Too much capital is chasing real estate, he complains, with hedge funds, private-equity groups, and rich investors all bidding up the same properties. "They've driven prices to the point where the yields on high-quality properties are like the returns on bonds, around 5% or 6%," says Barrack. "That's too low." And he sees the bubble deflating soon. Barrack thinks the catalyst will be a trend that few others are talking about, a steep rise in the price of building materials and labor. "Construction costs have spiked 30% in the past nine months," he says. The reasons: shortages of labor and materials like lumber because of the building boom, and increases in the price of oil, needed to produce everything from plastic piping to insulation to shingles.

The slump will show up first in speculative hot spots like Miami and Las Vegas, he says, where condo developers are preselling their projects for what look like big profits. When they actually build the units over the next year or two, he predicts, they will end up spending more than the units are now selling for. At that point, says Barrack, the developers will try to raise prices. "But most of these buyers are speculators," he says. "They will either sue the developers to get the original prices or get their deposits back and walk away." The developers will then put the units back on the market, and the glut of vacant condos will drive prices down. "It's the busted deals caused by construction costs that will cause a turn in the market," he predicts.

"It's the busted deals," Barrack says, "that will cause a turn in the market."

The bigger opportunities for real estate investors, Barrack says, lie in Europe—where the best deals are either politically sensitive or reserved for an exclusive club of investors that Colony is expert at courting—or in Asia, where growth is booming. Case in point: the Costa Smeralda resort in Sardinia, which Colony bought from Starwood Hotels & Resorts in 2003. (Starwood kept the hotel management contracts and a minority ownership in the undeveloped land.) Costa Smeralda's hotels are the world's most expensive, with summer rates averaging $3,000 a night. Yet the Aga Khan, the pioneer who built them, and later Starwood had been continually frustrated by the regional government's refusal to allow additional development on the site's 4,000 acres and 30 miles of coastline. The political thicket discouraged other buyers, allowing Barrack to acquire the property for just $340 million. To Barrack the political environment was an advantage: He cozied up to lawmakers and raised no objections to legislation that would block virtually all new development. "That means our competitors will be locked out," says Barrack. "The legislation will preserve our monopoly on five-star hotels! What could be better?"

Barrack has just made an even bigger deal in Asia, acquiring the prestigious Raffles hotel chain for $1 billion. For nine years Barrack had lobbied the principal shareholder, the government of Singapore, to sell it to him. For Singapore, Raffles was as much a point of pride as a moneymaker: With their majestic columns and polished mahogany bars, the Raffles hotels date from the British Empire and include such landmarks as the Raffles in Singapore and Le Royale in Phnom Penh. Barrack didn't emphasize how much Colony would pay; he wooed the Singaporeans with just what they wanted to hear: that Colony was the best choice to preserve and polish the Raffles name. The argument helped Colony prevail over competing bidders, including Fairmont, the Taj group of India, and Jumeirah of Dubai.

The deal includes ten Raffles hotels plus 26 Swissôtels, three-star properties mostly scattered throughout Europe. The hotels generate profits of about $60 million a year, a modest 6% return on Barrack's investment. But he plans to multiply their market value by expanding the Raffles brand in Asia. He points out that there are only three major five-star hotel chains based in Asia—Mandarin Oriental, Peninsula and Shangri-La—yet it's the world's fastest-growing hotel market. "We've had calls from over 200 developers who want Raffles to anchor their resort properties," says Barrack. He's planning to build 30 more five-star Raffles across the continent over the next five years.

Ever the opportunist, Barrack has even been willing to dip into the U.S. market despite his concerns about a downturn—when he can finagle an edge for himself, that is. He remains committed to the casino business, for instance. "It's unlike any other real estate business, because instead of having lots of buyers, there's a shortage of them," he says. "That's because the licensing laws create such high barriers to entry." Other U.S. properties occasionally catch his eye too. In January he plunked down $305 million to buy a rental-apartment tower on the ocean in Marina del Rey, near Los Angeles, from Zell's Equity Residential. Why? Barrack calculated that a quick conversion to condos would give him a windfall. The property had a dowdy image as a haven for middle-aged divorcées. In classic Barrack style, he found a way to turn that into an advantage. Giving the divorcée rap a sexy, glamorous twist, he commissioned ads featuring a 6-foot model from Brazil, who posed for a shoot on the tower's roof with a helicopter and fancy luggage. In the copy, which Barrack wrote himself, she declares, "You keep the house. I'll take the condo." The gambit has helped Colony sell 130 of the 420 units in just 60 days—a 1,500-square-foot two-bedroom with ocean views sells for $1 million. "The place is known as divorce heaven, so I decided to go with it!" he says. Given Barrack's history of making granite and glass sizzle, who's going to argue? F