



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 15

MEETING DATE: November 7, 2017

SUBJECT: Update on Core Real Estate Implementation Plan

SUBMITTED FOR: ___ Consent **Deliberation**
 and Action **Receive**
 X **and File**

RECOMMENDATION

Staff recommends the Board receive and file this update on the progress to date and next steps for transitioning SCERS' Core Real Estate separate account portfolios to open end commingled funds ('OECF').

PURPOSE

To inform the Board of Staff and Townsend's progress on developing and executing a Core Real Estate implementation plan for the orderly unwinding of SCERS' Core separate account exposure and the transition of the Core separate account assets into OECFs, as authorized by the Board in July 2017 and as consistent with the Real Estate Investment Policy Statement.

DISCUSSION

Staff and Townsend will present a review of the implementation plan, highlight key considerations, and the next steps necessary to execute the transition. The input from the Board during this discussion will be incorporated into the going forward implementation plan, with any necessary updates and reviews to be provided at an upcoming Board meeting.

Key implementation considerations for the transition from CSAs to OECFs include:

1. Which of SCERS' separate account assets will be contributed
2. OECF solicitation criteria
3. OECF selection process
4. Separate account asset transfer procedure

The implementation would entail a thoughtful process to phase out SCERS' separate account exposure. SCERS has six separate account properties (five with BlackRock and one with Barings), which are identified in greater detail within the Townsend presentation. Staff and Townsend presented two options for implementing the transition of the separate account portfolio: (1) Sell the assets in the open market; or (2) Exchange the portfolio for shares in a OECF. Staff and Townsend have determined that the transferring of SCERS' separate account assets in exchange for shares in OECFs is the most prudent implementation approach. The key advantages of this approach are as follows:

1. SCERS would receive immediate exposure to a diversified OECF, without the timing/pacing challenges associated with selling the assets individually or as a portfolio in the open market.
2. The sale process is expected to be quicker than selling assets individually or as a portfolio (90-120 days versus 12-36+ months).
3. SCERS should save on commissions typically paid to a third party in an outright sale.

Considerations associated with the exchange for shares in OECFs are as follows:

1. SCERS would receive appraisal pricing for a transfer, which could potentially generate less value than actively marketing the assets to ready and willing buyers.
2. OECF managers may not accept all assets.
3. Upon transfer, SCERS will have a large and concentrated position in one diversified OECF.

SEPARATE ACCOUNT TRANSITION PLAN

To gauge the market's receptiveness to exchanging SCERS' assets for OECF fund shares, Townsend surveyed the universe of OECF managers for feedback. From this initial outreach, Townsend believed there would be enough interest to solicit the manager universe for a formal indication of interest. Staff and Townsend identified a couple of important considerations for the managers to address in their response, including: (1) Fund liquidity and any lock-up period; (2) Whether the OECF will take SCERS' entire separate account portfolio or select SCERS separate account assets; (3) The current entry and exit queue within the OECF, to determine whether there are current net inflows or outflows into the fund ; and (4) Fund fees.

Invitations were sent out to 17 OECF managers, with responses received from 13 managers. One manager did not respond, while three others elected not to participate since SCERS' assets did not fit within their fund's portfolio construction. From this list of 13 managers, Townsend's Open-End Fund team suggested a group of seven potential managers to move to the next underwriting step.

The exchange of SCERS' assets for fund shares does not necessitate a cash obligation; however, Staff expects to conduct its typical due diligence on the seven identified managers, as defined in the implementation protocol within the Real Estate IPS, to identify the manager that best meets SCERS' Real Estate program investment objectives and structure. As stated

above, a consideration with the exchange of separate account assets for share in a OECF is upon the transfer of assets, SCERS will have a large and concentrated position in one diversified OECF. To mitigate this consideration, as part of the due diligence process, Staff is focused on identifying a manager with the potential to deliver top quartile performance over the long-term and whose investment strategy is sustainable. While a favorable outcome will be to receive the highest value for SCERS' assets, considerable consideration will be given to a OECF's future performance expectation, portfolio construction, strategy execution, firm resources, management team, and intangibles.

During the underwriting process, Townsend and Staff will also obtain separate account individual property appraisals for each of SCERS' separate account assets from an independent national appraisal firm, Altus, which is a provider of appraisal services to 22 OECFs. Having Altus provide appraisals for all of SCERS' separate account assets will provide SCERS with economies of scale through cost savings versus having multiple appraisal firms appraise SCERS' assets separately.

Staff and Townsend expect a 30 – 45 day period to conduct manager evaluation and analysis, which will include manager interviews by Staff and Townsend. Final manager candidates will be requested to provide a written purchase/exchange proposal, which will be compared against the Altus appraisals, with a manager identified for consideration to occur 30 – 45 days thereafter. With a 90-day timeframe in mind, Staff and Townsend are targeting the selection of a OECF manager, and the completion of the portfolio transition by the end of the first quarter of 2018.

ATTACHMENT

Townsend Presentation of SCERS Real Estate Separate Account Portfolio Transition Plan

Prepared by:

/s/

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Investment Officer

Reviewed by:

/s/

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Chief Investment Officer

/s/

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Interim Chief Executive Officer



TOWNSEND[®]
GROUP

**Sacramento County Employees' Retirement System
Real Estate Separate Account Portfolio Transition Plan**

November 7, 2017



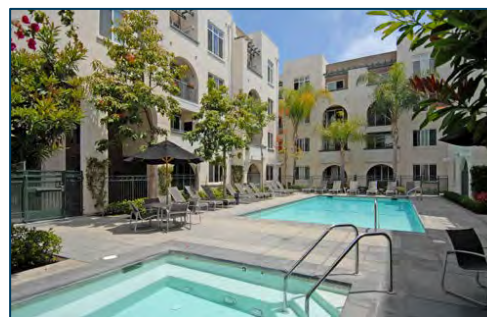
SCERS Separate Account Portfolio Transition Plan

Overview of Separate Account Assets (6/30/2017)

Name	Property Type	City, State	SF or Units	% Leased	Est. NAV	Mortgage	Est. GAV
Core Assets							
Lake Washington	Office	Seattle, WA	72,237	100%	\$ 38.80	\$ -	\$ 37.60
The Tower at Hollywood Hills	Apartment	Los Angeles, CA	80	92%	\$ 16.08	\$ 11.00	\$ 28.80
Harbour Point	Retail/Grocer Anchored	Everett, WA	113,449	94%	\$ 38.47	\$ -	\$ 41.90
1811 Brittmore	Industrial	Houston, TX	140,181	81%	\$ 12.22	\$ -	\$ 12.90
Hillside Village	Apartment	Berkeley, CA	94	92%	\$ 41.93	\$ 13.50	\$ 58.10
Sub Total-Manager 1/Core					\$ 147.51	\$ 24.50	\$ 179.30
Crescent Park-Manger 2	Apartment	Los Angeles, CA	214	95%	\$ 68.45	\$ 39.00	\$ 107.50
Sub Total-Manager 1+2/Core					\$ 215.96	\$ 63.50	\$ 286.80
Non-Core Assets							
Leland James/Block 295	Office (90/10 JV)	Portland, OR	119,625	6.5%	\$ 20.44	\$ 25.40	\$ 45.84



1811 Brittmore



Crescent Park



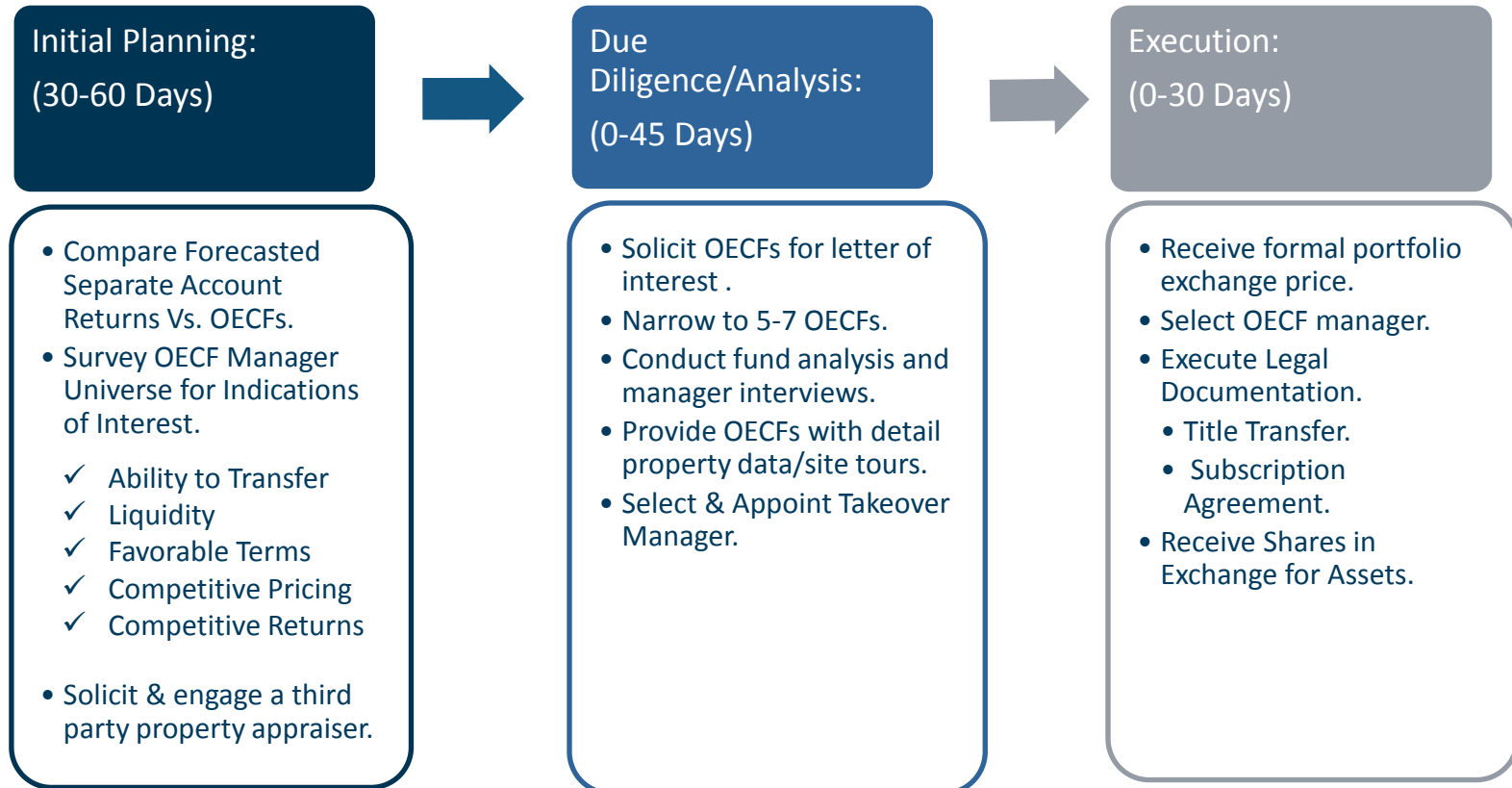
Harbour Pointe

SCERS Separate Account Portfolio Transition Plan

SCERS Separate Account Transition Plan

- In July 2017, the SCERS Board authorized Staff and Townsend to proceed with a Separate Account Transition Plan.
 - Thoughtfully phase out SCERS’ separate account exposure.
 - Focus core real estate exposure through Core Open-End Commingled Fund (“OECF”) investments going forward.
- SCERS Core Program Implementation Options:
 1. Sell Separate Account Assets.
 - Ask SCERS Separate Account Managers to present a plan for an orderly sale of the remaining assets in the SCERS Separate Account Portfolio.
 - » Advantages: SCERS may receive competitive market pricing, SCERS managers have knowledge of existing portfolio.
 - » Disadvantages: SCERS may face challenges selling assets and risks owning Separate Account assets for an extended period, SCERS will face transaction costs, SCERS may face challenges redeploying proceeds from asset sales.
 2. Transfer Separate Account assets to OECFs in exchange for shares.
 - Survey universe of OECF managers to determine whether they are interested in an exchange program.
 - » Advantages: SCERS will receive immediate exposure to a diversified OECF.
 - » Disadvantages: Upon transfer, SCERS will have a large and concentrated position in one diversified OECF.
- In August, Staff and Townsend agreed feedback was needed to gauge the interest of OECF managers to exchange SCERS’ separate account portfolio for fund shares.

SCERS Separate Account Transition Plan: Comprehensive Timeline



SCERS Separate Account Portfolio Transition Plan – Detailed Timeline

SCERS Separate Account Transition Plan

July

- The SCERS Board approved the restructuring plan for the Core Portfolio.
- Townsend and Staff communicated the plan with the existing Separate Account managers.
- SCERS was removed from the BlackRock and Barings acquisition pipeline.

August

- Townsend worked with its OECF team to identify possible candidates for the takeover assignment.
- Townsend solicited indications of interest from 17 OECF Managers, including SCERS' existing Separate Account Managers.

September

- Townsend received interest from 13 OECFs (executed Non-Disclosure Agreements).
- Townsend provided summary property level information to interested OECFs.
- Townsend requested completion of a short questionnaire identifying fund fees, liquidity, and willingness to accept SCERS' entire portfolio.
- BlackRock and Barings (formerly Cornerstone) obtained bids for third party appraisals.
- Townsend reached out to Altus, a national appraisal firm and provider of appraisal services to 22 OECFs, to submit a bid for an appraisal of all of SCERS' assets. Economies of scale and price savings would be achieved by having Altus appraise the entire portfolio versus using multiple firms.

SCERS Separate Account Portfolio Transition Plan – Detailed Timeline

SCERS Separate Account Transition Plan

October

- Townsend reviewed each of the OECF submissions and along with internal underwriting reports-recommended a list of 5-7 top quartile OECFs to underwrite further.
- Staff and Townsend believe it is important for SCERS to obtain an independent valuation as a confirmation of OECF submissions.
 - Altus provided a proposal to appraise the SCERS portfolio at a significant savings to appraising single assets by multiple firms.
 - » The Altus proposal was \$14,000 or ~\$11,000 less than proposals received from firms suggested by Blackrock and Barings.
 - » Three of SCERS' separate account assets were already scheduled to be appraised this year but will now be included with the Altus portfolio appraisal.

SCERS Separate Account Portfolio Transition Plan – Underwriting Considerations

SCERS Separate Account Transition Plan

Key Underwriting Considerations of OECF Manager Candidates

- Historical performance, portfolio construction, platform stability, investment strategy, fund liquidity, fund terms/conditions, projected returns, and SCERS portfolio fit.
- Use of debt, debt terms, value creation strategies, in-place rents versus market, fund level expenses, growth projections, diversification, etc.
- OECF manager purchase/exchange proposals against the Altus appraisal report.

Next Steps

- Appraise Assets
- Analyze each of the OECF manager candidates' historical and projected performance, portfolio construction/diversification, investment and value creation strategy, and fund fees and liquidity.
- Interview OECF Managers.
- Evaluate written purchase/exchange proposals from select OECF manager candidates.
 - Proposals will be evaluated against the Altus appraisals.
- Select OECF Manager.
 - Negotiate with selected manager.
 - Complete Fund legal documentation and property level documentation.
 - Sell assets in exchange for fund shares.