COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Public Investment Memorandum

Florida - 3 Multi-Family Property Portfolio (Separate Account)

Core Real Estate Commitment

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March 23, 2018

Recommendation:

Staff, together with Courtland Partners, LTD., recommends to the Board a commitment of up to $215 million to a to-be formed-LLC (100% owned by PSERS) that will acquire a three property multi-family portfolio located in central and southern Florida from Bell Apartment Fund IV (in which PSERS made a $75 million commitment in 2012).

The three property portfolio consists of 837 A/B+ multifamily units located in central and southern Florida with a purchase price of $196.5 million. The total capitalization is $215 million (inclusive of closing costs, initial working capital budget, start-up / improvement costs and a 1% contingency).

Investment Overview:

In 2012 PSERS committed $75 million to Bell Fund IV, a $200 million Value-Add apartment fund. Fund IV has performed well and is nearing the end of its Investment Period (initial term ends December 31, 2019 with two one-year extension options).

The Fund purchased 13 assets, and has since sold eight assets, leaving five remaining assets in its portfolio.

Fund IV has received approval from its Advisory Committee to sell three Florida assets to a Bell-managed entity. PSERS abstained from the vote to avoid any potential conflicts of interest.

The free and clear transaction value was established by averaging two third-party appraisals for each of the three properties. Appraisals for each property were prepared by CBRE and Newmark. Each appraisal has been reviewed by staff and staff is comfortable with the valuations.

The sale generates an attractive return for Fund IV investors and provides PSERS with an opportunity to acquire a lower risk, stable, income oriented portfolio.

The properties will be held in a to-be-formed holding company with 3 separate titles and operate as a separate account. This separate account will be managed for PSERS by Bell.

Bell will continue to act as both property and asset manager for the portfolio. Management continuity will be advantageous to PSERS as Bell has done an excellent job at managing these properties for Fund IV. That intimate portfolio history in conjunction with the absence of a transition period allows the manager to focus more on optimizing the property performance rather than onboarding new assets.

Additionally, the properties will not be rebranded. The signage, internet footprint, forms, etc will all be kept the same so that the public will still associate these properties with Bell. As such, PSERS will be able to capitalize on the Bell name which is recognizable and well regarded in the apartment management space.

One blanket loan to the ownership entity for the three properties will be provided from the internally managed PSERS Core Fixed Income portfolio.

Manager Overview:

Established in 1976, Bell Partners Inc. ("Bell" or the "Company") is a privately held, vertically integrated apartment investment and management company focused on high-quality multifamily communities throughout the United States.

Bell Partners is a top-15 apartment operator, with approximately 50,000 homes across 14 states and the District of Columbia, and is one of the largest apartment renovators in the industry. The Company has approximately 1,250 associates and 8 offices (including its headquarters in Greensboro, NC) and offers an extensive and full-service operating platform containing expertise in acquisitions and dispositions, financing, property operations, accounting, risk management and other related support functions.

Bell Partners is led by a senior management team with an average of over 23 years of experience that has invested throughout all phases of the real estate cycle and has helped the Company complete over $13 billion of apartment transactions since 2002.

PSERS began its relationship with Bell in 2012 when it made a $75 million commitment to its $200 million Bell Apartment Fund IV ("Fund IV"). Additional investments totaling $150 million were subsequently made in two fund vehicles (Bell Funds V and VI) whose combined equity was $1,025 million, and a subsequent $10 million co-investment was made in 2014 in a single property joint venture.

To date, performance for all Bell investments is either in line with, or in excess of, original expectations.

Market Opportunity:

The U.S. multifamily market remains very dynamic, with peak development and demand levels. Performance is good, although not as stellar as earlier in the cycle. However, the long term outlook is very positive as the U.S. population continues to expand and homeownership rates in the U.S. remain near historical lows.

The U.S. multifamily sector continues to boast the lowest vacancy rate of the four major property types with a 4.9% vacancy rate as of September 30, 2017. While up 30 bps from the prior quarter, it is still 250 bps less than the 10-year peak vacancy of 8.0% at December 31, 2009.

Multifamily demand remained very strong in 2017, as evidenced by the 241,200 units absorbed over the year—the second-highest annual total during the recovery/expansion period. Multifamily demand has been fueled by a confluence of factors concerning mortgage underwriting, a growing population and the impact of Generation Y.

The Generation Y ("Gen Y") cohort, currently 25-34 years old and 80 million plus strong, is the largest cohort in U.S. history, exceeding even that of the Baby Boomers (77 million). This generation has exhibited the strongest propensity to rent as capital costs to own homes and down payment requirements present barriers to home ownership, particularly when saddled with the burden of student loan debt.

From the end of 2009 through September 30, 2017, the Gen Y unemployment rate fell from 9.4% to 4.4%. As a result there has been a de-coupling within the Gen Y cohort (i.e. more household formations) which is also driving demand for multifamily product. Baby boomers, looking to downsize, are also contributing favorably to multifamily demand. Additionally, the U.S. population is expected to grow by a net 79.6 million people from 2014 to 2050. Approximately 38% (or 30 million people) will be foreign born and foreign-born people have a higher tendency to rent rather than own homes. All of this will positively impact the multifamily sector.

From a supply perspective, much has been talked about the high levels of deliveries into the market in the past four years. From 2010 through 2012 annual completions averaged 142,000 and grew to 251,000 units, 309,000 units, 315,000 units, and 300,000 units in 2014, 2015, 2016 and 2017 respectively. While annual completions are expected to remain north of 300,00 units in the next two years, this is below the projected 440,000 annual level needed to meet forecasted demand in the coming years.

The recent supply increase has been counterbalanced by solid demand as evidenced by vacancy rates remaining in check. The overall vacancy rate increased slightly (10 basis points) to 4.9% year-over-year in Q4, which is quite healthy, although it represents the seventh consecutive quarter in which vacancy edged up on a year-over-year basis. Vacancy rose by 30 basis points (bps) between Q3 and Q4, due to normal seasonal patterns. Historically, the Q4 vacancy rate has increased by an average of 50 bps from Q3 since 1996.

The 20-year historical average for annual rent growth is 2.6%. Multifamily rent growth peaked in Q1 2015 (6.1% year-over-year) and has been moderating to more normal levels since this time.

Q4 rent statistics by type of submarket have not yet been released. In Q3, however, suburban submarkets registered a 1.6% year-over-year rent gain, while rents in the urban core submarkets fell by 2.3%.

Among all markets, Orlando had the highest year-over-year effective rent increase at 5.8% (a notable rise from 4.6% in Q3). In addition to Orlando’s robust economy, multifamily demand is rising from an influx of Puerto Rican residents who were displaced by Hurricane Maria.

In general, the outlook for multifamily in the near and long term is positive, particularly in the heavy to light value add end of the spectrum.

With positive underlying fundamentals, a successful multifamily property investment will also heavily rely upon a property’s submarket, its location within that submarket relative to its competitive set, neighborhood amenities, proximity to employment, quality schools, surrounding infrastructure, on-site amenities, barriers to entry and solid management.

Portfolio Fit:

A commitment to the investments will be allocated to the Core Real Estate portion of PSERS' Real Assets portfolio. Using the net market value from September 30, 2017, and adjusting the unfunded to include commitments from the prior and current Board meetings, the Real Estate portfolio would be 20.5% Core, 44.5% Opportunistic, and 35% Value-Added.

The table below summarizes PSERS' projected exposure inclusive of a recommended $96.5 million commitment to the investments and excludes exposure to the open-end redemptions:

Investment Type ($M)	Market Value(1)	%	Unfunded	%	Total Exposure(1)	%	Long Term Target (%)
Core	1,567.3	25.9%	170.3	7.1%	**1,737.6**	**20.5%**	**20%**
Opportunistic	2,813.2	46.5%	947.7	39.4%	**3,760.9**	**44.5%**	**30%**
Value-Add	1,670.1	27.6%	1,288.7	53.5%	**2,958.8**	**35.0%**	**50%**
Total	**$ 6,050.7**	**100%**	**$ 2,406.6**	**100%**	**$ 8,457.3**	**100%**	**100%**

(1) Includes Gross PTRES Exposure

Investment Strategy:

Our investment strategy is to acquire a portfolio of high quality, institutional, income producing, core-plus multi-family assets in robust markets and partner with a best-in-class manager to maximize returns to PSERS. Capital improvements will be made to drive net operating income (NOI) and remain competitive in the submarket. Market conditions and PSERS' portfolio needs will be monitored on an ongoing basis to determine timing of a sale.

Investment Highlights:

Stable, income producing assets
• This portfolio of core plus assets is projected to generate a steady cash flow. • Upside will be in the capital improvements to be done to further drive rental income
Submarket fundamentals projected to trend positively
• Like every multi-family property, this portfolio will have sensitivity to occupancy levels and market rents. The subject portfolio's submarkets are showing stable occupancy levels, moderate rent growth and favorable absorption. These metrics are anticipated to trend positively through 2022.
Well located properties
• All three properties are well situated in their respective markets with respect to employment centers, major roadways, retail and other amenities which gives them competitive advantage over lesser situated properties.
Curb appeal with modern amenities
• The portfolio has been physically well maintained and has modern amenity packages that appeal to the consumer.

- Bell is constantly evaluating and adjusting amenities to keep abreast of consumer preferences while being accretive to NOI.

Unique attributes set subject properties apart from the competition

- Each property has differentiating factors which will help it maintain its competitive edge going forward. One property has all townhouse style units, another property is one of two rental properties in a sought after school district and a submarket with high barriers to entry and the third property, recognized for its superior design, is also proximate to a highly rated school district and at the doorstep to Universal Studios theme park.

Highly regarded Bell management team will remain in place

- The continuity of the Bell management team is favorable both the eyes of the consumer as well the portfolio’s bottom line. Bell is recognized as one of the top managers in the multifamily space.

Interest rate sensitivity

- The portfolio will be financed with a fixed interest rate thereby eliminating interest rate sensitivity.

Investment / Risk Considerations:

Rent growth

- Rent growth in the subject portfolio has consistently outpaced its submarkets and this trend is anticipated to continue. Projected rent growth in the portfolios submarkets is 3%. Additionally, capital improvements planned at the properties will command higher rental rates going forward.

Vacancy

- Projected market vacancy is 94-95%; long term average has been 93-95%. In our underwriting we have modeled vacancy at 92-94%. With solid underlying economic fundamentals and slowing deliveries, vacancy rates are not anticipated to deviate materially from their historic levels
- Submarket demographics are favorable and demand for apartment product is projected to be stable
- Subject properties have unique characteristics which sets them apart for their competition and gives them a competitive edge

Cap rate expansion

- Interest rate expansion will increase the cap rate and thereby decrease the investment’s IRR
- However, interest rate expansion will likely occur in an environment of increasing inflation with costs of goods (like rental income) moving in lockstep.
- Staff and the asset manager will monitor the portfolio closely to optimize the timing of a sale

Manager performance

- Bell is a proven manager in this asset class and is recognized as such by its peers, competitors and industry consultants.
- In the unlikely event that Bell does not perform, a replacement manager, selected by PSERS, can be brought in to manage the properties.

Finance Committee Disclosure:

Relationship with Courtland Partners, Ltd.:	Bell's relationship with Courtland Partners, Ltd. consists of meeting their requirements (i.e. reporting needs) to facilitate PSERS' investments with Bell Partners.
Placement Agent:	Not applicable to current Florida Portfolio offering. CBRE and Atlantic Partners were used during prior Bell Institutional Fund capital raise processes.
PA Political Contributions:	N/A; $0
PA Presence:	N/A; Bell Fund II, LLC had an interest in one PA property (Bell Elkins Park) alongside additional Bell high net worth investors, which was sold in 2014.
Conflicts:	Given Bell's experience in managing multiple investment entities, it believes it has appropriate procedures in place to mitigate any conflicts that may arise between investment entities. Each prior fund has advisory committees to resolve any conflicts that may arise. The three underlying assets that comprise the current Florida Portfolio offering are currently owned by Bell Fund IV. Waiver of conflict approval was required by both the Bell HNW Fund IV and Bell Institutional Fund IV advisory committees to offer the Florida Portfolio to a Bell managed entity given the potential conflicts. Approval was received by both advisory committees in February, and PSERS recused themselves from a vote on the Bell Institutional Advisory Committee given our interest in the transaction.
History with PSERS:	PSERS's has 4 total investments with Bell Partners, which include the following commitments: BIF IV ($75 million), BIF V ($75 million), BIF VI ($75 million) and Bell Woodstock ($10 million).
PSERS Allocation Implementation Committee Approval:	

Oversight Responsibility:

Investment Office:	Charles J. Spiller	Deputy CIO, Non-Traditional Investments
	Melissa A. Quackenbush	Senior Portfolio Manager
External Consultant:	Courtland Partners, Ltd.	

COURTLAND PARTNERS, LTD.

MEMORANDUM

TO:	Pennsylvania Public Schools Employees' Retirement System ("PSERS")
FROM:	Courtland Partners, Ltd. ("Courtland")
DATE:	February 21, 2018
RE:	Bell Partners ("Bell")/ Fund IV Portfolio Acquisition

In connection with the winding down of Bell Partners Fund IV ("Fund IV"), PSERS is considering the acquisition of three assets from Fund IV (the "Transaction") and has requested Courtland to review and comment on the Transaction. Courtland's review has included i) a review of the Fund IV Portfolio Sale memorandum prepared by Bell for PSERS and dated February 12, 2018 (the "Bell Fund IV Memorandum"); ii) participation by phone in the PSERS/ Bell meeting held in Harrisburg on February 12, 2018; and iii) several phone discussions with PSERS personnel. Based on its review, Courtland supports a decision by PSERS to move forward with the Transaction.

Fund IV closed in 2013 with $200 million. Fund IV invested in thirteen multifamily assets with a total cost of $536.5 million, realized eight assets to date, and is planning on a near term sale of the other five assets. Three of these assets (two in Ft. Lauderdale and one in Orlando) are the subject of the Transaction. Approximately 60% of Fund IV is liquidated. PSERS investment in Fund IV was $75 million, therefore total distributions to PSERS should aggregate approximately $135 million.

The three assets in the Transaction, consisting of 837 total units, have a total gross asset purchase price of $196.5 million, established by averaging two appraisals on each property. The Transaction, including price, has been approved by the other Fund IV limited partners, and closing would be targeted for April/ May 2018.

The Bell Fund IV Memorandum includes an extensive description of the three assets, including physical characteristics, location, local economic and multifamily market conditions, and opportunities to add future value. It also includes extensive and detailed financial analyses and projections. Bell will continue to manage the assets and will be the asset manager in this separate account Transaction.

Courtland believes that given the current real estate market environment, attractive asset locations, quality of these stabilized assets, and proven Bell management that the Transaction presents a favorable risk/reward real estate investment opportunity for PSERS.

Please let us know if you have any comments or questions.