

NORTH CAROLINA  
DEPARTMENT OF STATE TREASURER



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INVESTMENT MANAGEMENT DIVISION

# Real Estate Update

February 20, 2019



## Agenda

- I. Real Estate Team
- II. Real Estate Market Conditions
- III. Role and Objectives
  - Core and Non-Core Comparison
- IV. Real Estate Allocation
- V. Real Estate Cash Flow
- VI. Manager Concentration
- VII. Cost Efficiency
- VIII. Performance
  - Core
  - Non-Core
- IX. Unfunded Commitment Pacing
- X. Investment Strategy Initiatives
- XI. Appendix
  - NCRS Investment Approach
  - Total Performance vs. REITs
  - Leverage
  - Property Type Diversification
  - Geographic Diversification
  - Example Investment Characteristics



## Real Estate Team

Troy March, CCIM, MBA  
Portfolio Manager

5.5 Years with IMD  
17 Years Industry Experience

Tinh Phan, Licensed Broker  
Portfolio Manager

5 Years with IMD  
19 Years Industry Experience

Jack Wilson  
Analyst

1 Year with IMD  
3 Years Industry Experience



## Real Estate Market Conditions

- Overall tough to find value especially through Core acquisition strategies
- Capital continues to be plentiful, supporting current pricing levels, cap rates expected to remain neutral in 2019
- Core income continues to be strong but appreciation will likely be modest
- Lots of dry powder in debt strategies, terms remain prudent but need to be monitored closely for loosening of lending standards

### Multifamily

Strong job growth helped absorb elevated supply in 2018. Demographic trends continue to provide tailwinds and long-term drivers of demand remain relevant.

### Office

Healthy macroeconomic drivers, but fundamentals are decelerating. Supply growth is mostly in check while densification continues to be a drag on demand growth.

### Retail

Class A/A+ and small strip-center retail are surviving, and may even present investment opportunity now. B/C malls and big-box power centers continue to weaken.

### Industrial

Demand continues to outpace record levels of new supply creating strong rent growth, especially in the in-fill markets. Build-to-Core offers the best expected go-forward return.

### Hotel

Strong economy and healthy consumers continue to hold up demand. Supply and demand roughly in balance. RevPar continues to grow faster than inflation.

### Other Niches

Becoming more mainstream. Positive spread to primary sectors is tightening. Data centers and Cell-Towers are strong; Student, Senior, Medical-Office, Self-Storage are all stable.



## Role and Objectives

### Core Thesis

*“To generate durable income and stable returns through strategic investments, with prudent use of leverage, in assets with long-term fundamental drivers that will endure for generations”*

### Investment Strategy

High Quality  
Well Located  
Strong Risk-Adjusted Returns

### Non-Core Thesis

*“To achieve attractive risk-adjusted net returns through appreciation and income from a diversified portfolio, planning for strategic exit optionality”*

## Core

Inflation hedge

High current income

Stabilized occupancy

Credit tenancy

Long-term return > fixed income

Minimal risk/downside protection

## Non-Core

Growth diversifier

Opportunity to add value

Renovation, development, leasing

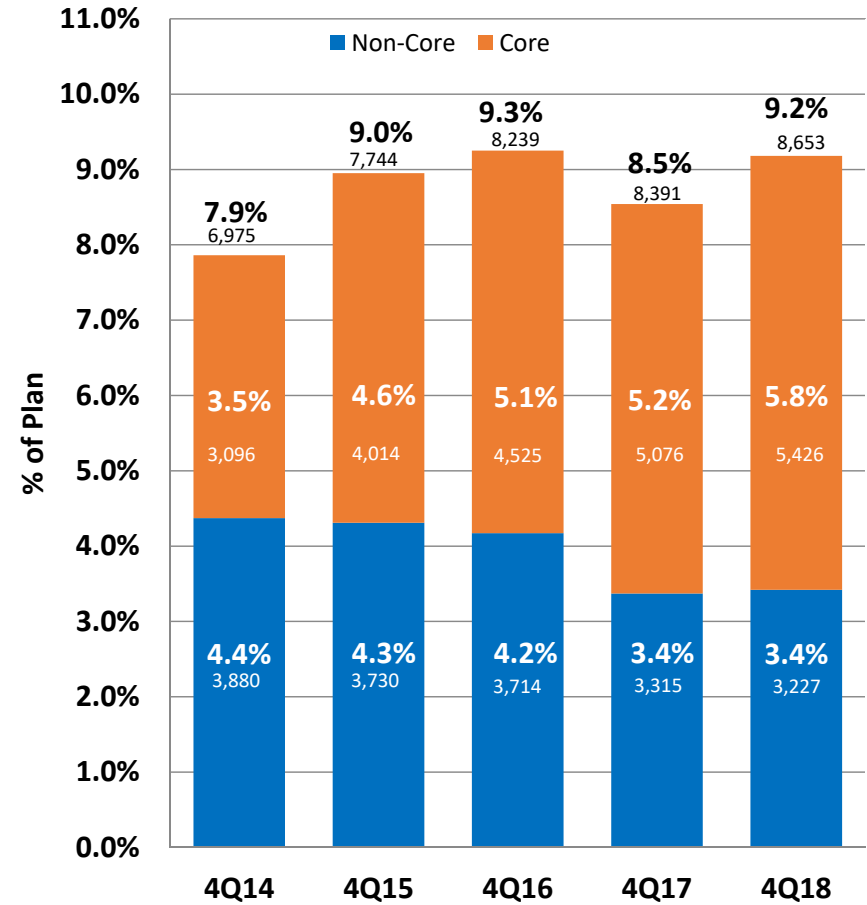
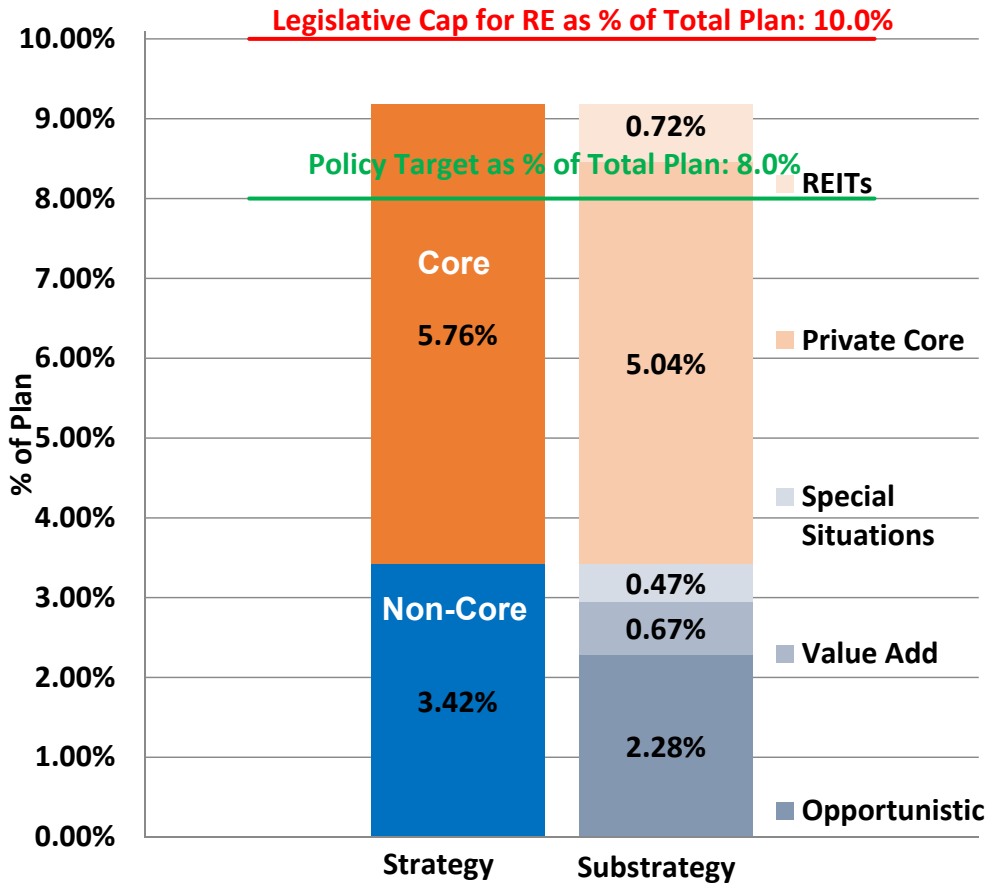
Stabilized upon completion

Long-term appreciation and returns

Low correlation to fixed income



# Real Estate Allocation



NCRS data as of 12/31/18  
Special Situations – Build-to-Core Strategy

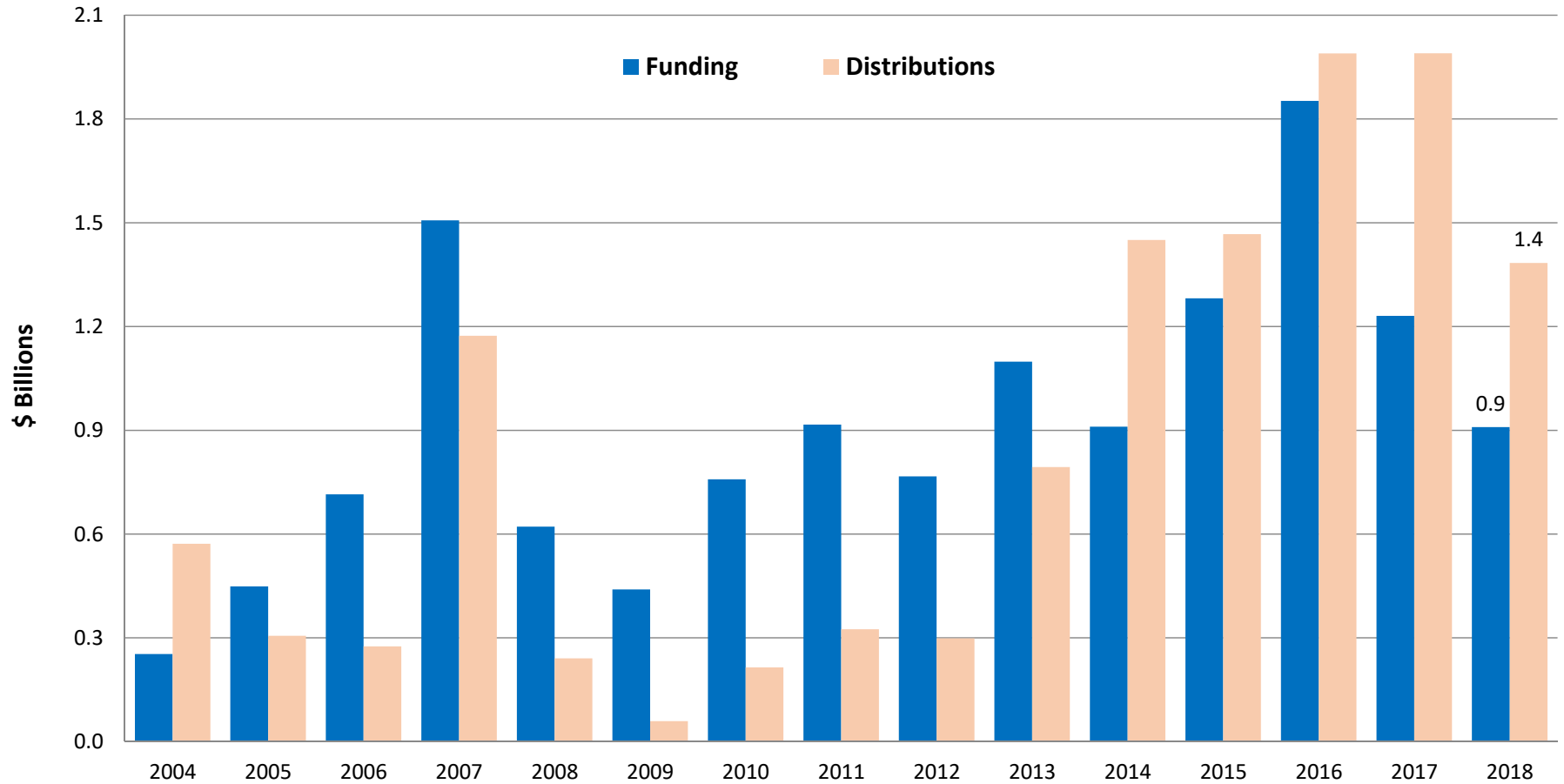
Plan MV 88,801 86,571 89,104 98,264 94,226

\$ in millions

YE 2018 allocation increase is attributable to investment gains and denominator effect



## Real Estate Cash Flow



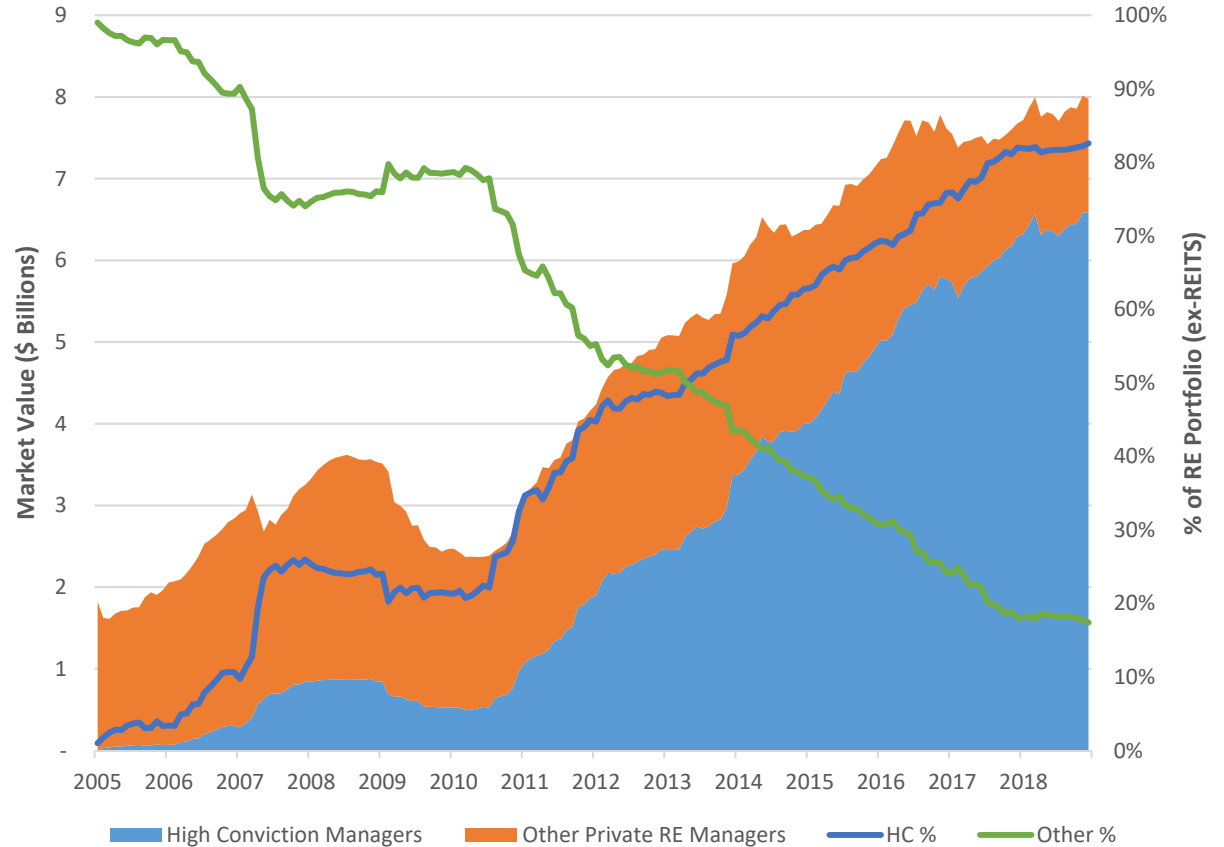
Commitments (\$M):	380	1,205	1,885	1,402	915	0	343	1,265	1,005	1,211	1,798	1,575	1,965	250	300
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NCRS data through 12/31/18

Net realized distributions year-to-date (12/31/18) of ~\$475 million.

## Manager Concentration (excludes REITs)

Contribution to Return			
	3 Year	5 Year	7 Year
<b>Private Core</b>	<b>8.0</b>	<b>8.5</b>	<b>9.5</b>
High Conviction	7.2	7.2	7.2
Others	0.8	1.3	2.3
<b>Non Core</b>	<b>12.5</b>	<b>14.3</b>	<b>13.2</b>
High Conviction	8.2	9.7	9.0
Others	4.2	4.7	4.1



\* "High Conviction" Managers are identified by the Real Estate Team as General Partners with the highest probability of meeting/exceeding expected fund-level returns

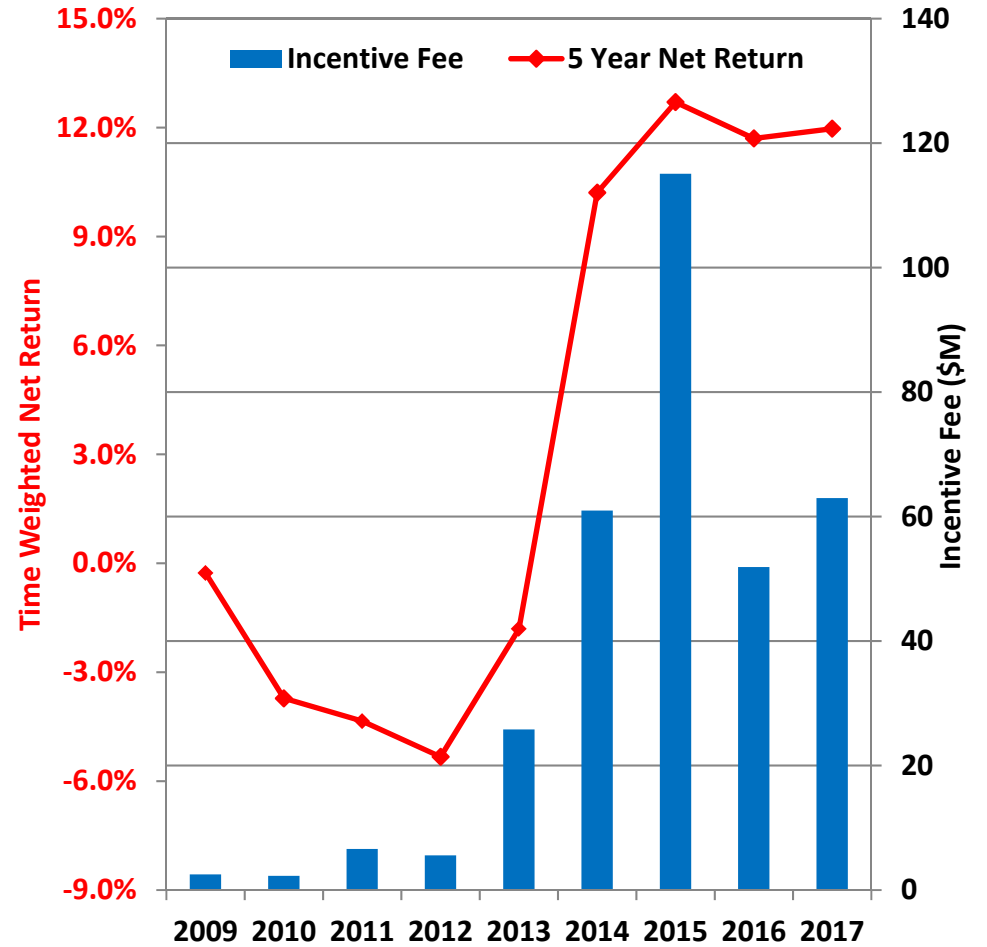
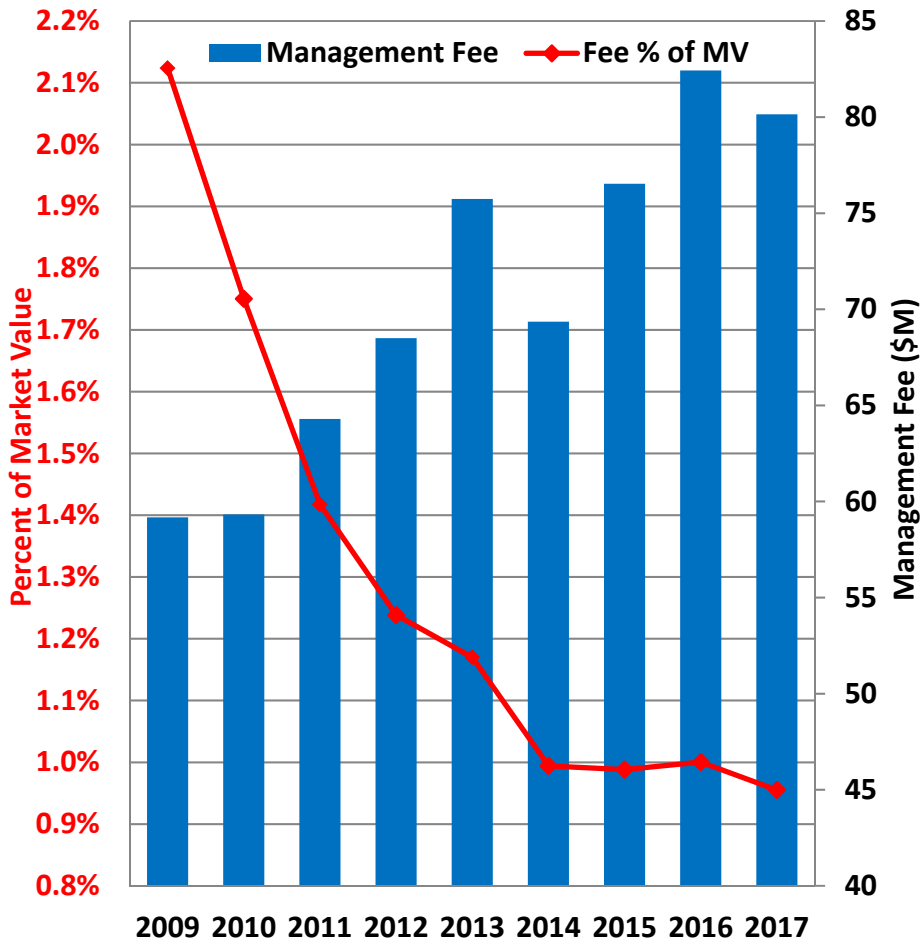
NCRS data through 12/31/18

83% of private market value is with high conviction managers –  
Concentration helps reduce complexity and fees, increases transparency and maximizes returns.





# Cost Efficiency



NCRS data through 12/31/17

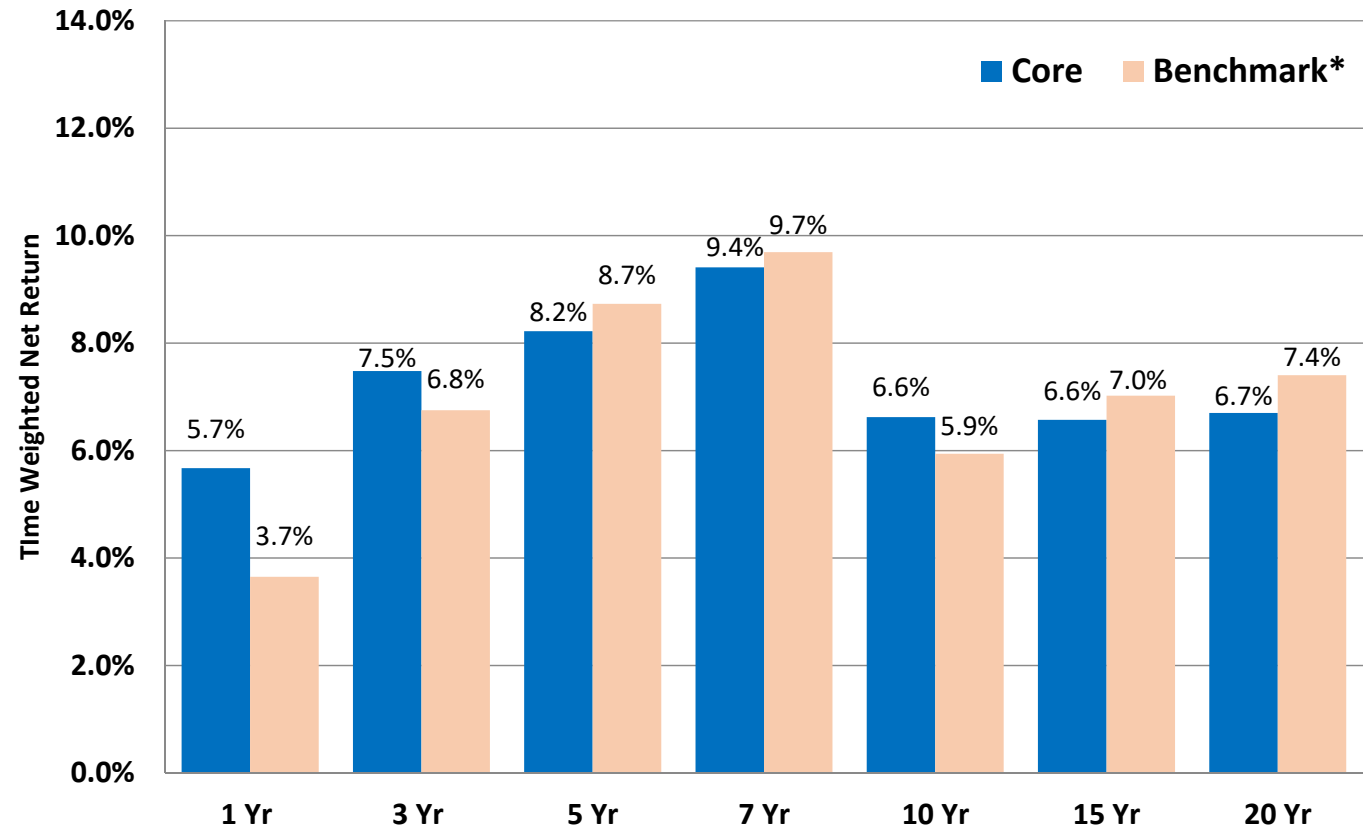
2015: Convergence of delayed realization of GFC funds, early realization of post GFC funds, and an Industrial manager selling their entire platform

Leverage relationships and scale to minimize costs and enhance alignment.



## Performance: Core Real Estate

Core Contribution to Return		
3 Year		Contribution
Private Core RE		6.8
REITs		0.7
<b>Total Core</b>		<b>7.5</b>
<u>Major Drivers</u>	<u>Vintage</u>	
PC NorthRock Core	2008	1.5
PC BPP	2014	0.8
PC NorthRock II Core	2012	0.7
5 Year		
5 Year		Contribution
Private Core RE		7.0
REITs		1.3
<b>Total Core</b>		<b>8.2</b>
<u>Major Drivers</u>	<u>Vintage</u>	
PC NorthRock Core	2008	1.8
PC JP Morgan SPF	1989	1.3
PC BREP Edens	2013	0.8



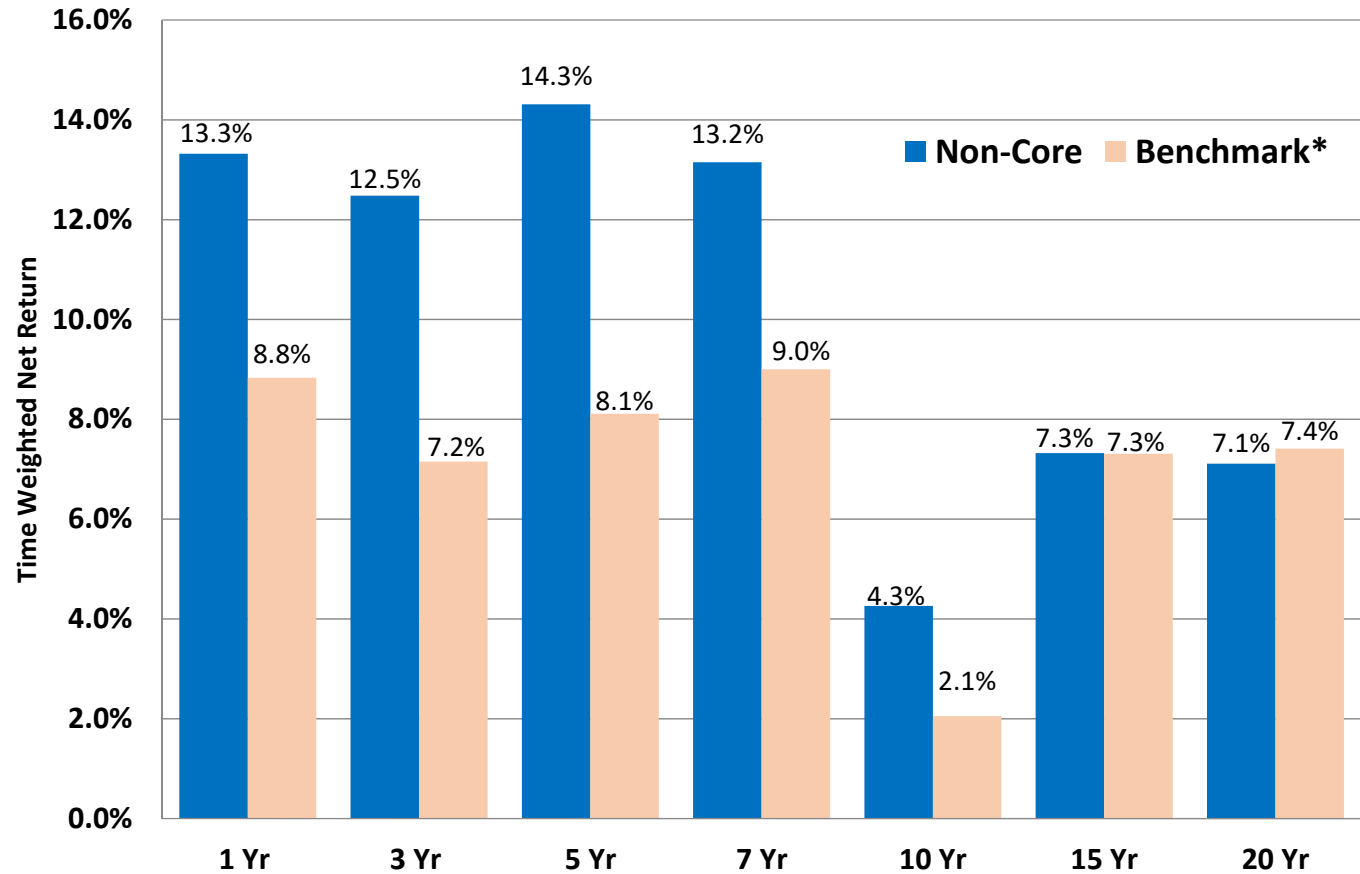
NCRS data through 12/31/18

\* The Core Real Estate Benchmark is comprised of 80% NCREIF ODCE Net and 20% FTSE EPRA NAREIT Global Index.

Core real estate portfolio has started to outperform the benchmark as core plus investment strategy moves through the J curve.

## Performance: Non-Core Real Estate

Non-Core Contribution to Return		
3 Year	Contribution	
Opportunistic	8.1	
Value Add	4.4	
<b>Total Non-Core</b>	<b>12.5</b>	
<u>Major Drivers</u>	<u>Vintage</u>	
O NorthCreek	2011	2.1
O BREP Europe IV	2013	1.1
V DRA GIF VII	2011	1.0
5 Year		
	Contribution	
Opportunistic	9.0	
Value Add	5.4	
<b>Total Non-Core</b>	<b>14.3</b>	
<u>Major Drivers</u>	<u>Vintage</u>	
O NorthCreek	2011	2.1
O BREP VII	2011	1.1
V Northrock II	2012	1.0



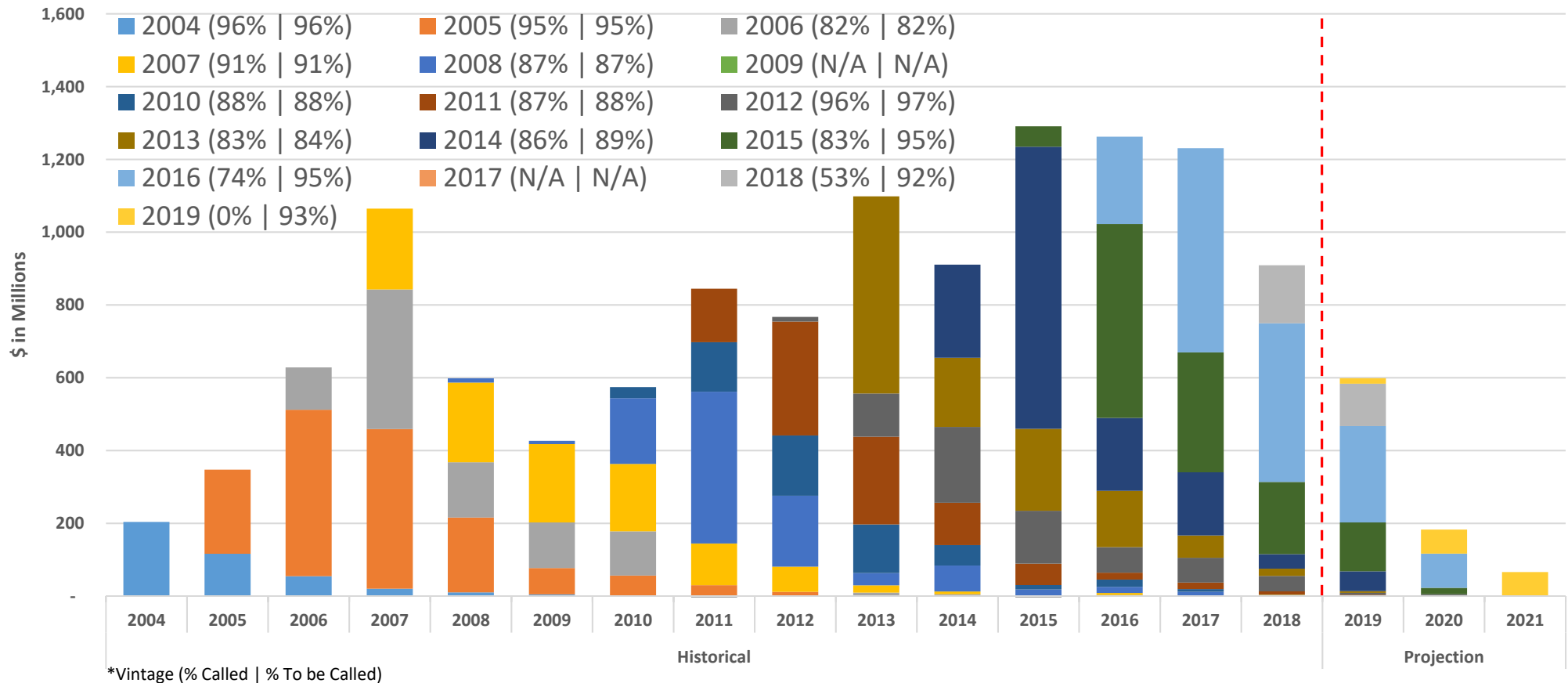
NCRS data through 12/31/18

\* Non-Core Real Estate Benchmark is comprised of the following Burgiss Group Private iQ indices: 80% U.S. Non-Core Real Estate (Opportunistic and Value-Added) and 20% Non-U.S. Non-Core Real Estate (Opportunistic and Value-Added).

Non-core portfolio continues to outpace the benchmark by a significant margin due to strong performance in separate accounts and high conviction managers.

## Unfunded Commitment Pacing

Contribution Pacing by Vintage Year (excludes REITs)



Of the \$2.2 billion in unfunded commitments at 12/31/18, we project \$850 million will be called by 2021 and approximately \$440 million will be held as reserves and is unlikely to be called.



## Investment Strategy Initiatives

### High Conviction Managers

- Continue to increase allocation to high conviction managers and reduce manager count
  - More attractive terms (e.g. fee discounts for loyalty and size)
  - Greater control and transparency (e.g. Separate Accounts, custom solutions, founding Limited Partner)

### Cost Efficiency

- Minimize costs and maximize returns by favoring fee structures that optimize alignment

### Sector Allocation

- Target new commitments in property types that enhance portfolio construction
- Favorable long term risk/return profiles
- Diversification benefits



## Appendix

- i. NCRS Investment Approach
- ii. Total Real Estate Performance vs. REITs
- iii. Leverage
- iv. Property Type Diversification
- v. Geographic Diversification
- vi. Example Investment Characteristics



## Investment Approach

Stay the course with our investment strategy...do not reach for yield

- Downside protection
- Eye toward current income for core or speed to income for opportunistic strategies
- Moderate leverage levels

Use thoughtful & deliberate portfolio construction

- Stabilize Core portfolio
- Diversify by strategy, property sector and location
- Balance asset risk and market risk by insisting on the highest asset quality and location
- Target specific submarkets and streets

Leverage the size of our plan & skill set of our team

- Better terms & fees
- More transparency and control
- Ability to move quickly to capitalize on opportunities & dislocations
- Be the founding investor for new strategies with high conviction managers

Invest meaningful amounts with fewer best-in-class managers

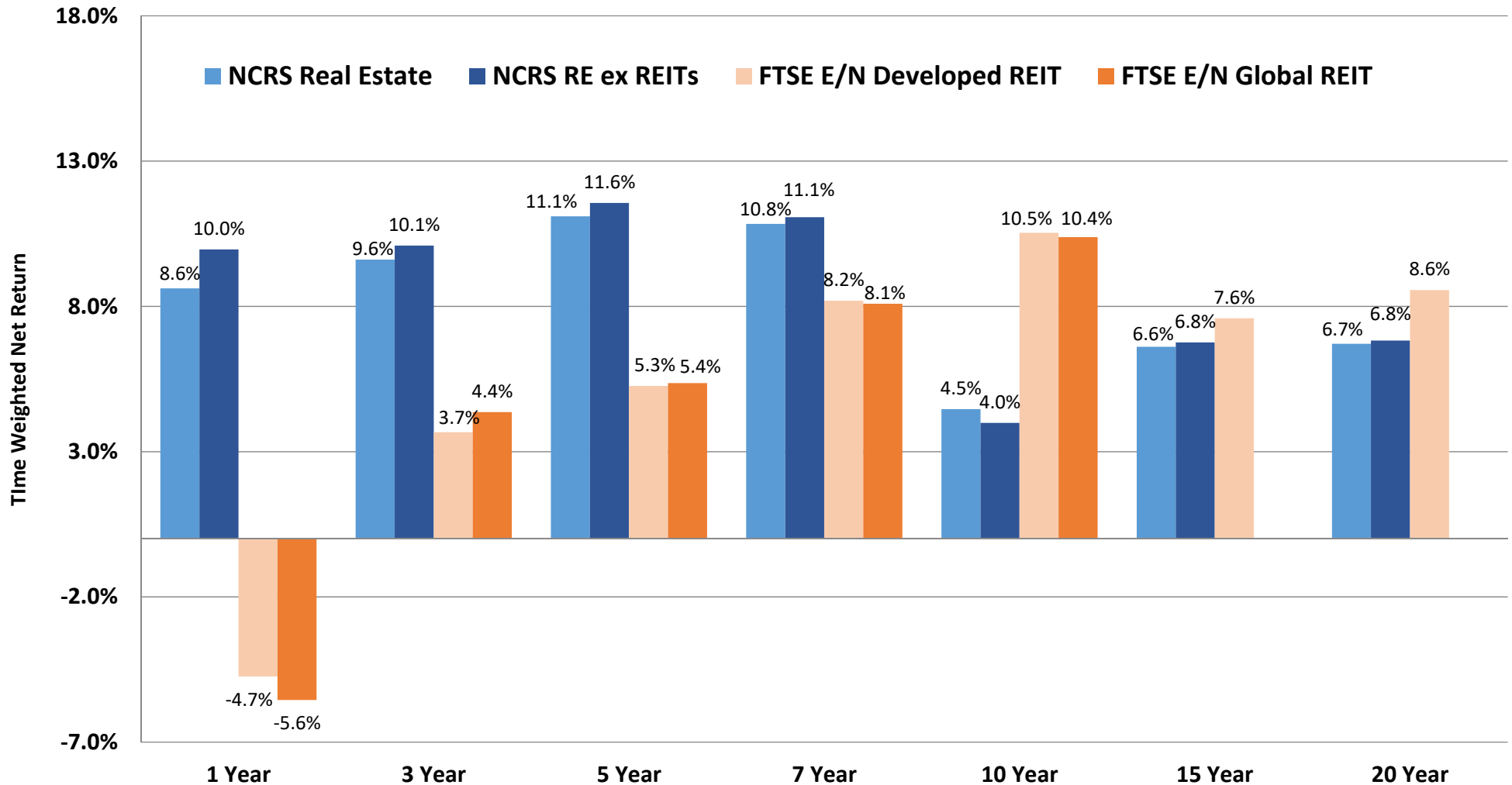
- Separate accounts
- Multiple strategies with single manager
- Fee benefits

Take a long-term view toward investments and manager relationships

- Be involved, be nimble and follow through
- Deliver results
- Be a leader among Limited Partners



## Performance: Total Real Estate vs. REITs



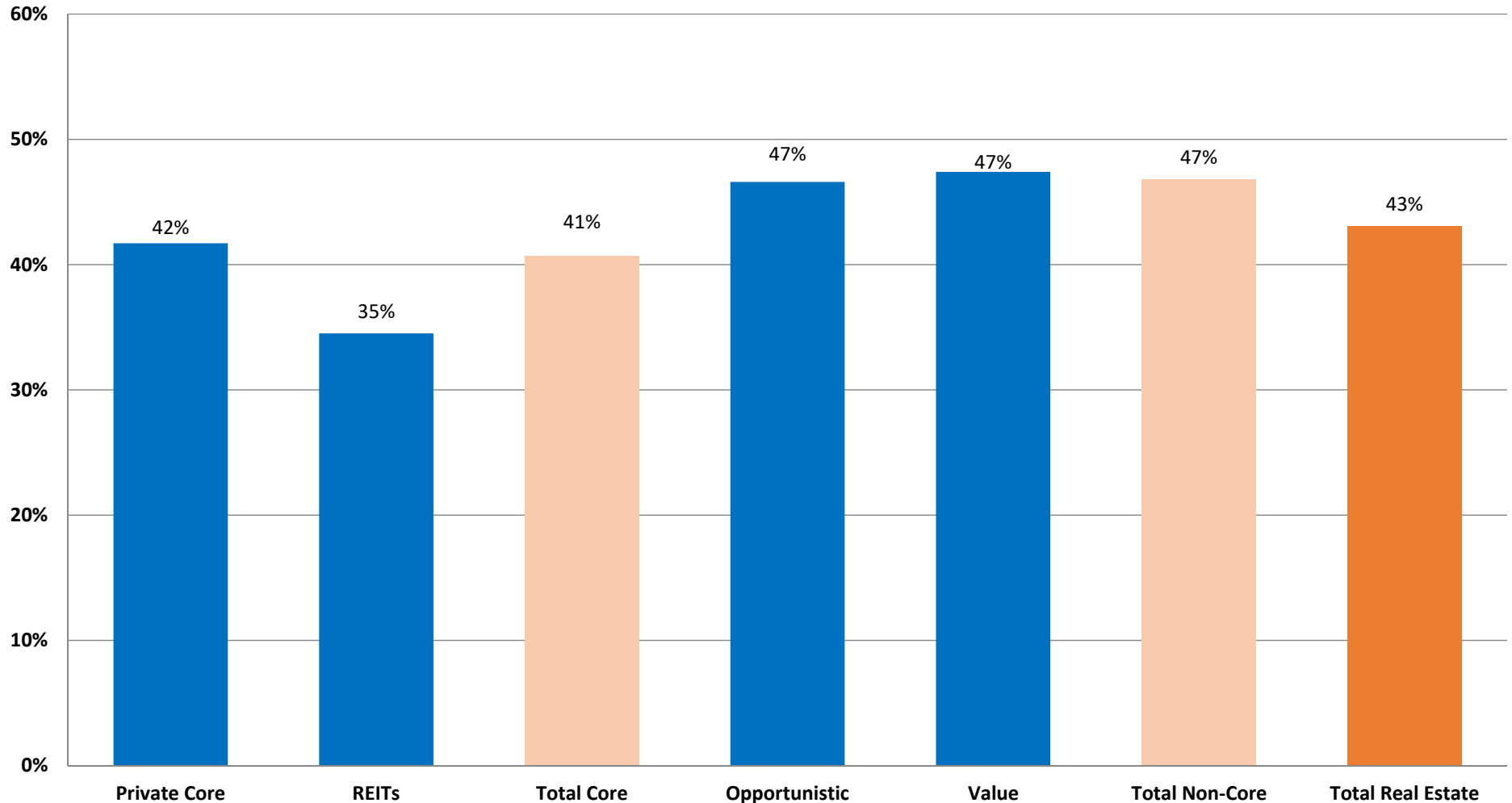
NCRS data through 12/31/18

FTSE EPRA/NAREIT Developed Index: The index serves to represent real estate equities across developed markets of North America, Europe and Asia.  
FTSE EPRA/NAREIT Global Index: The index is designed to track the performance of real estate equities in both developed and emerging markets.





## Leverage

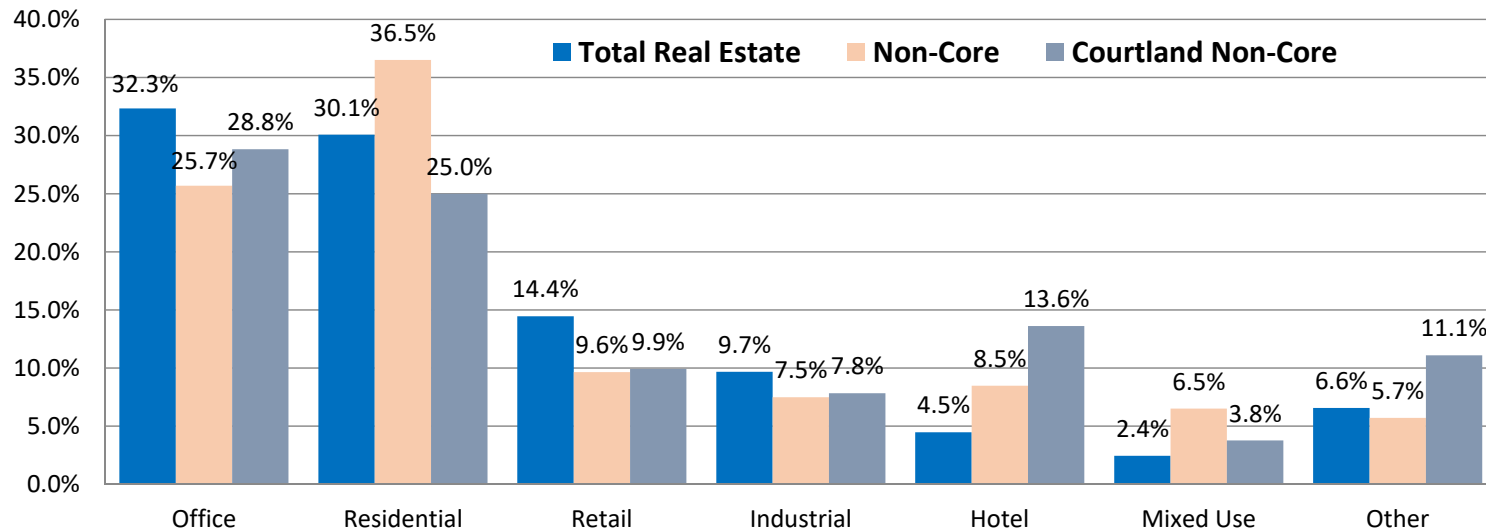
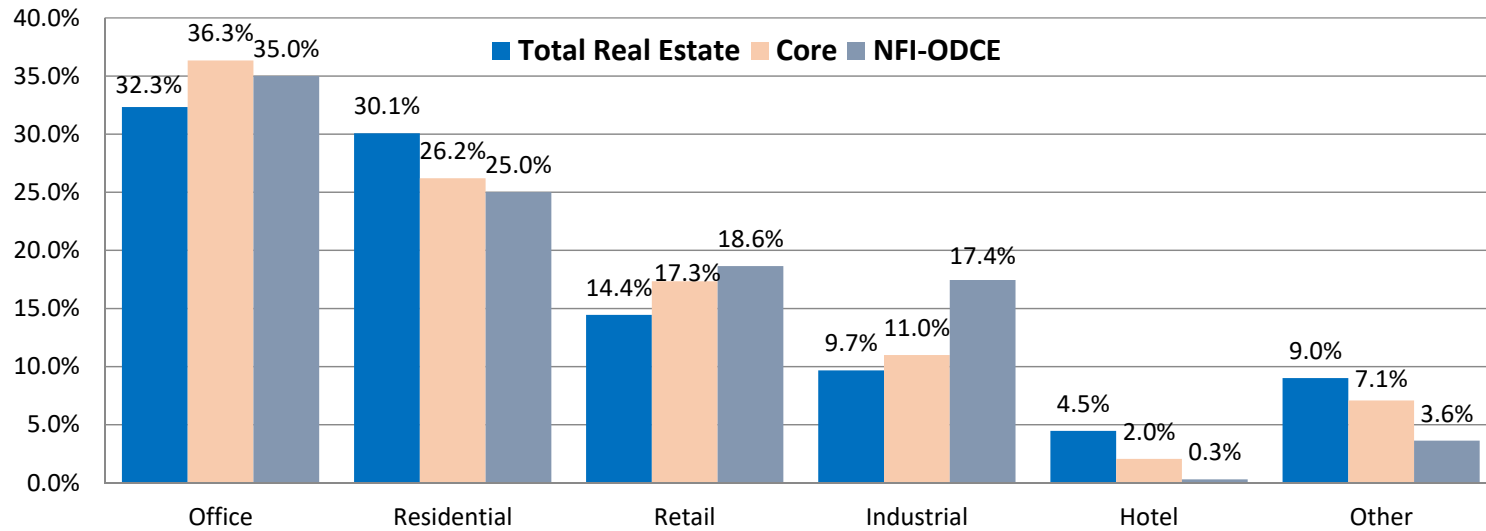


Source: Courtland Partners NCRS 2Q18 PMR

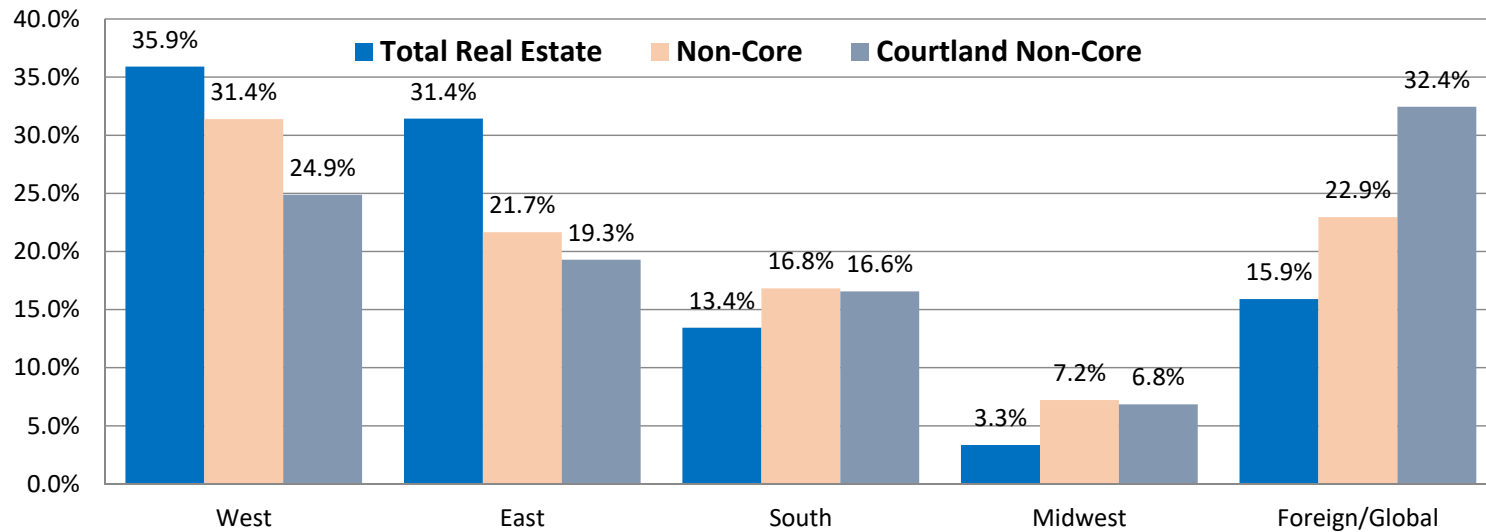
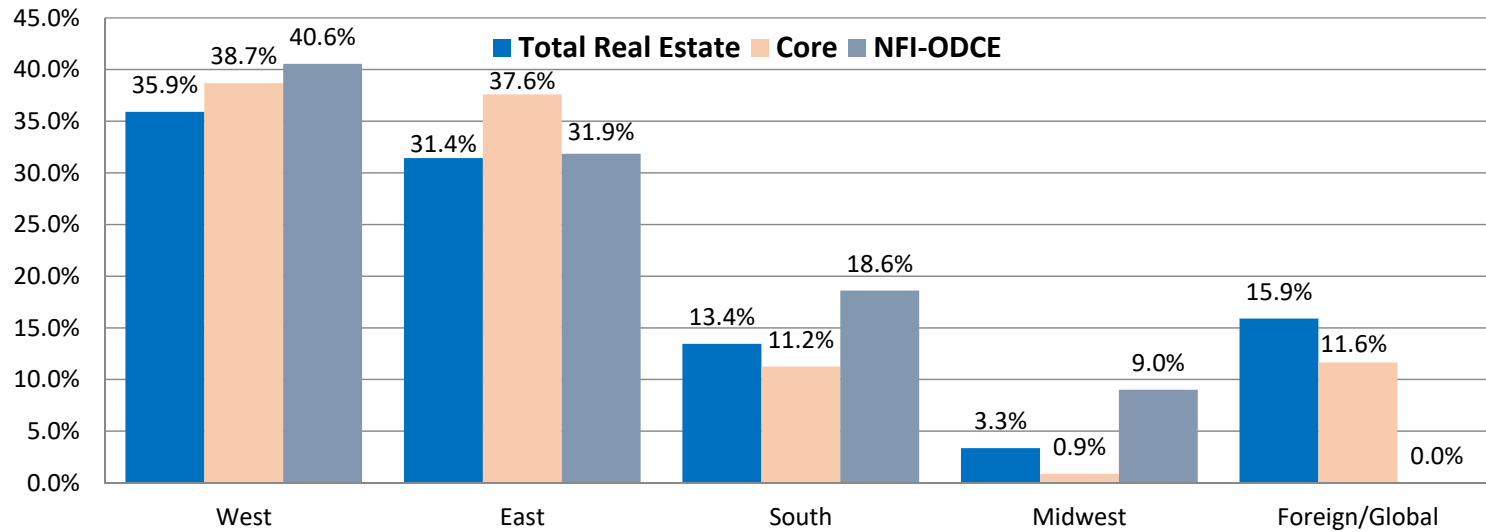
Maintaining prudent levels of leverage and retaining ability to adjust through our Separate Accounts.



## Property Type Diversification



# Geographic Diversification





## Example Investment Characteristics

Strategy	Total Gross Return	Distribution Income/Appreciation	Leverage
Core	7 - 9%	80/20	< 40%
Core Plus	9 - 11%	70/30	< 50%
Value-Add (Non-Core)	11 - 16 %	30/70	up to 60%
Opportunistic (Non-Core)	> 16%	10/90	up to 75%