

## G.2. Program Management

### A. Overview

In compliance with current ERS investment philosophy, the Real Estate Investment Program will utilize discretionary separate account relationships and discretionary commingled fund investment vehicles that are sponsored by real estate investment managers (“Investment Managers”). Under this program, the Investment Managers acquire, operate and dispose of real estate assets in accordance with a work assignment that is outlined in their investment management contract with the ERS (the “Contract”) and in the Annual Tactical Plan for separate accounts and the fund documents for commingled funds. The Contract describes the acceptable property types, geographic restrictions, investment structures, leverage and other specific investment parameters. The Annual Tactical Plan is the Investment Manager’s “working plan” for each fiscal year and must be reviewed by Investment Staff and Real Estate Consultant (Refer to Section IV: Control and Monitoring Systems) and approved by the Board of Trustees. Commingled fund documents typically refer to the fund’s offering memorandum or private placement memorandum, limited partnership or LLC membership agreement, and subscription agreement.

### B. Participant Roles and Responsibilities

The ERS’s Real Estate Investment Program shall be implemented and monitored through the coordinated efforts of the Board of Trustees; through the Investment Staff; the ERS’s general investment consultant (“General Investment Consultant”); the ERS’s real estate consultant (“Real Estate Consultant”); the Investment Manager(s); and external appraisers (“Appraiser” or “Appraisers”). Specific responsibilities that fall outside the general responsibilities highlighted in Section B.5. are listed below:

1. **Investment Manager** - Qualified real estate organizations, registered as Investment Advisors under the 1940 Act that provide institutional real estate investment management services to the ERS. ERS may invest in commingled fund vehicles that are not registered, however, it is preferred that the commingled fund be sponsored and/or managed by a Registered Investment Advisor.

**Separate Account Manager Responsibilities** - The separate account Investment Manager, acting as a fiduciary on behalf of ERS, acquires, manages and disposes of real estate properties and/or originates or acquires, manages, and realizes upon real estate debt investments in accordance with the annual Tactical Plan and Contract. The Investment Manager retains appropriate property management and loan servicing expertise and shall (1) recommend to Investment Staff and the Real Estate Consultant qualified appraisers annually; (2) complete internal valuation estimates of the real estate assets managed by them on behalf of the ERS quarterly; and, (3) provide any additional information regarding valuation requested by Investment Staff or the Real Estate Consultant.

**Commingled Fund Manager Responsibilities** – The commingled fund Investment Manager, acting as a fiduciary on behalf of ERS, acquires, manages and disposes of real estate properties and/or originates or acquires, manages, and realizes upon real estate debt investments in accordance with the terms of the investment vehicle documents.

2. **External Appraisers** - Independent real estate valuation experts selected to provide their opinions regarding the current values of the ERS's real estate separate account investments. While the Appraiser selection process is further described in Appendix G.5 of this section, the Appraisers shall have at a minimum the industry or governmental certifications and designations (e.g., Member of the Appraisal Institute or an MAI) required by the Investment Staff and the Real Estate Consultant. The Appraisers shall be recommended by the Investment Managers and approved by the Investment Staff and the Real Estate Consultant. The selected Appraisers shall have reasonable experience and expertise in the property type and geographic location of the individual property or asset being valued.

### C. Portfolio Composition

The real estate program will be comprised of two different but complementary components – core and specialty.

1. **Core Portfolio** - Core investments include equity or debt investments on existing, substantially leased income-producing traditional property types located principally in metropolitan areas that exhibit reasonable economic diversification. Core properties, therefore, must have the following characteristics:
  - Traditional institutional quality property types including office, industrial, retail and multifamily; also included are medical office, senior housing, storage, and student housing properties that demonstrate core characteristics;
  - Operating and stabilized properties that demonstrate predictable income flows with a high proportion of anticipated total return arising from current income and cash flow;
  - At least 70% leased upon purchase of the asset;
  - Located in institutional markets and in economically diversified metropolitan areas;
  - High credit quality tenants and a staggered lease maturity schedule;
  - Quality construction and design features;
  - Reasonable assurance of a broad pool of potential purchasers upon disposition;
  - Properties requiring quality asset and portfolio management but not requiring specialized operating expertise which is not readily available in the market;
  - Investment structures using all cash or low leverage. Leverage is limited to 50% on each investment;
  - Total gross return expectations between 6% and 8% per year.

Core properties can be further classified as:

- Trophy
- Commodity

**Trophy** properties represent dominant and unique properties that cannot be easily reproduced due to such factors as legislative limitations and physical constraints. Trophy properties are typically located in only the largest metropolitan areas often with a significant global environment.

**Target Portfolio**

The long-term real estate strategy is for the ERS real estate portfolio to be diversified by geographic regions and property type within the following target ranges:

**Geographic Regions**

West	20-50%
Midwest	5-30%
South	10-35%
East	10-40%
International (Non US and Canada)	10%-20%

**Property Types**

Apartments	10-40%
Industrial	10-30%
Office	10-50%
Retail	10-30%
Other*	0-20%

\* “Other” includes property types not classified by the NCREIF Index, such as, hotels, motels, residential housing, senior housing, medical office, storage, student housing, and raw land.

3. **Ownership Structure** - The ownership structure for Core investments includes leveraged and unleveraged equity and debt investments owned 100% by ERS or owned jointly with Suitable Investment Partners. “Suitable Investment Partners” include public, corporate and union pension plans, foundations and endowments, insurance company general accounts or separate accounts, and other tax-exempt institutions, having the same or greater standards of fiduciary care and responsibility as those imposed by ERS guidelines. When dealing with specialty investments that are directly owned, Operating Partners shall be added to the list of “Suitable Investment Partners.” The ownership structure of Specialty assets within commingled funds will be governed by the fund documents.
4. **Leverage** - Leverage may be utilized in a constrained manner in the Core portfolio in order to enhance yields of the various investments and/or facilitate the diversification of the portfolio. The use of debt must result in positive leverage where cash flow is in excess of debt service. The total expected return to ERS over the term of the investment must be expected to increase a minimum of 2 basis points for each 1% of leverage, as a result of leverage. For example, leverage returns on an acquisition with 50% debt should be higher than the unleveraged returns for the same property by a minimum 100 basis points. The total level of debt for any single investment will not exceed fifty percent (50%) of the value of that asset for core investments and 75% for specialty investments. Total portfolio debt will be limited to thirty percent (30%) in the core portfolio, 65% in value added investments and 75% in opportunistic investments. The single investment debt level will be measured for compliance at the point leverage is added to the portfolio. The total portfolio debt levels will be measured for compliance at the point leverage is added to the portfolio or a portfolio asset is purchased or sold.

### **G.3. Real Estate Investment Process**

#### **A. Manager Selection**

In an effort to maintain program simplicity and ensure appropriate underwriting of investment management organizations, the ERS shall utilize only ERS approved real estate investment management firms for the acquisition, asset management and disposition of property and origination, management, and realization of debt investments. In addition to the existing separate account Investment Managers, the ERS has approved a program of commingled fund investing. Each Investment Manager will be provided a specified capital allocation. Investment Manager capital commitments shall periodically be balanced in accordance with the overall real estate strategic allocation objectives.

#### **B. Transaction Review And Closing - Separate Accounts**

- 1. Investment Identification** - Upon identifying a specific investment that meets the program guidelines and Tactical Plan objectives, the Investment Manager must provide to the Investment Staff and Real Estate Consultant, a written summary of the property characteristics, investment structure and notification of joint venture partners and/or investment partners in the format provided in Appendix G.1.
- 2. Property Closing and Funding** - Once the Investment Manager identifies an investment that meets portfolio objectives, the Investment Manager shall provide to the Investment Staff and Real Estate Consultant a Critical Dates list which includes scheduled funding dates, wire transfer instructions and other important timing information. In addition, the Investment Manager shall prepare a Closing Report as appropriate. Upon close of the investment, the Investment Manager shall provide to ERS a summary of all uses of capital funded by the ERS.

#### **C. Asset Management - Separate Accounts**

In conjunction with its asset management responsibilities, the Investment Manager must comply with the reporting requirements as outlined in Appendix G.2. Revisions to the original ten year pro forma and capital budget that require unscheduled capital fundings must be presented to the Investment Staff for review; however, it is not necessary to present to staff unscheduled capital fundings that were already described in the annual property plans. Refinancing or partial dispositions that were not approved as a part of the Annual Tactical Plan must also be presented to the Investment Staff.

#### **D. Disposition – Separate Accounts**

Annually, the Investment Manager must review each property managed by it on behalf of ERS and complete a “hold” or “sell” analysis. Assets targeted for sale are identified and documented and a brief explanation of the sell decision and strategy is provided to the Investment Staff, the Real Estate Consultant, and the Board at the annual Tactical Planning presentation. In addition, the Investment Manager must submit to the Investment Staff and Real Estate Consultant notification of any unsolicited sales offers. Once an offer is accepted by the Investment Manager, the Investment Staff and the Real Estate Consultant must be provided with a Critical Dates list that details the disposition activities.

**E. Commingled Fund Investments**

The ERS does not anticipate using the commingled fund vehicle for additional Core investing unless a specific niche strategy makes it otherwise compelling (e.g., specialty debt investing). Rather, separate accounts are the preferred vehicle for Core investments. However, commingled fund vehicles may be used to access “specialty investments” to meet its 30% target as stated above. The selection process used to invest in commingled funds is similar to the process used to retain separate account Investment Managers. Selection criteria for commingled funds shall include minimally conflicted fee structures and maximum investor controls. In addition, the ERS shall use similar strict control and monitoring systems to evaluate the commingled fund Investment Managers as used for evaluating the separate account firm.

## G.4. Control and Monitoring Systems

In real estate investing, separate and distinct from other strategic classes, the Investment Manager has direct control over the operations of the assets. This inherent conflict of interest contributes to the lower volatility associated with the strategic class but also creates a need for greater oversight by the ERS. The Board of Trustees shall be notified by the Investment Staff and the Real Estate Consultant of Investment Manager reporting problems, significant organizational changes such as mergers, and prolonged under-performance. Investment Managers performing below expectations in any of the before mentioned areas shall be placed on the “watch list” outlined below. All Investment Managers will be subject to an annual review in Hawai‘i and may also be called in by the Investment Staff or Board for a special review. Finally, the ERS also recognizes that it may elect to terminate separate account Investment Managers within thirty (30) days for “cause” as outlined in the Contracts. The ERS shall manage the Real Estate Investment Program in the following manner:

### A. Annual Reporting Requirements

#### Separate Account Investment Managers

1. **Tactical Plans** - Annually, the separate account Investment Manager prepares a Tactical Business Plan, an outline of which is in Appendix G.3. In the Tactical Plan, the Investment Manager outlines its targeted investment plan including the basis upon which targets have been established. The Plan must include property/investment type, investment structure, return expectations and exit strategies as well as any other pertinent strategy specific parameters. This Plan is to be completed or revised every year and submitted to the Investment Staff and the Real Estate Consultant. The plan shall be presented in September of each year, unless otherwise directed by the Investment Staff or Board, and, if appropriate, shall be approved by the Board.
2. **Asset Management Plans** - The separate account Investment Manager must also prepare annual asset management plans for each managed by the firm and owned by the ERS. Asset management plans include property-specific operating budgets; estimates of cash to be distributed to the ERS, management fees, debt service, lease expirations and rollover, and all other relevant property information. A sample outline is included as Appendix G.4. Asset management plans are due thirty days prior to the ERS fiscal year end and are to be submitted to the Investment Staff and Real Estate Consultant. When submitting the annual asset management plan, the Investment Manager should review any significant line item variances (greater than 10% and \$25,000) from the prior year.
3. **Investment Manager Reviews** - At least annually, and as often as twice a year as determined by the Board, the Investment Staff and Real Estate Consultant shall coordinate an Investment Manager review presentation for the Board. Each review is required to discuss how the investments managed on behalf of the ERS have met the previous year’s plan as well as the program objectives of ERS. The Investment Manager’s organization is also reviewed. This monitoring system is designed to assist the ERS in identifying troubled investments and changes at the organizational level that may suggest additional monitoring is required.

#### Commingled Fund Managers

At least annually and as often as twice a year as determined by the Board, the Investment Staff and Real Estate Consultant shall coordinate an Investment Manager review

*APPENDIX G.3*

**EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII  
REAL ESTATE SEPARATE ACCOUNT  
TACTICAL BUSINESS PLAN OUTLINE**

**PURPOSE:** The Tactical Business Plan provides the manager an opportunity to articulate its capital allocation objectives for the ensuing 12 month period relative to the Work Assignment as outlined in each contract. Once a year the Tactical Plan is revised and all interim manager work should comply with the business plan. Variances should be discussed with the Investment Staff and Investment Committee. The following is the Tactical Business Plan outline for direct investments:

**I. EXPECTED PERFORMANCE (Net of Fees)**

1. Ratio of Current Versus Total Return;
2. Projected Initial Market Capitalization Rates;
3. Total Net Return Expectations - Both Nominal and Real; and
4. Return Trends For Sector Components (i.e. markets, property types such as community versus regional retail centers, operating life cycle).

**II. INVESTMENT OBJECTIVES AND OPPORTUNITIES**

1. Targeted Property Type (within work assignment);
2. Targeted Markets and Rationale;
3. Leasing Exposure - Occupancy and Rollover Pattern;
4. Tenant Mix Preferences;
5. Leverage; and
6. Special Opportunities.

**III. SELL DISCIPLINE**

1. Factors That Would Initiate a Sell; and
2. Properties Targeted For Sale and Rationale.

**IV. CAPITAL DEPLOYMENT**

1. Acquisition Objectives; and
2. Portfolio Repositioning.

**V. PROGRAM ADMINISTRATION AND TIMING**

1. Appraisals - Scheduled Internal or External;
2. Audits - Firm and Timing;
3. Insurance; and
4. Other Special Notices.