



State of Rhode Island  
Office of the General Treasurer

## MCR Hospitality Fund IV- Staff Recommendation

*January-2024*

### RECOMMENDATION:

- [Rhode Island Employees Retirement Systems Pooled Trust](#): Approve a commitment of up to \$15 million to MCR Hospitality Fund IV (“MCR IV”).
- [Rhode Island OPEB System Trust](#): Approve a commitment of up to \$450,000 to MCR Hospitality Fund IV (“MCR IV”).

**ASSET CLASS:** Non-Core Real Estate (ERSRI), Private Growth – Non-Core Real Estate (OPEB)

**SUB-STRATEGY:** Value-Add Hotel

### ALLOCATION:

- [Rhode Island Employees Retirement Systems Pooled Trust](#): The target allocation for Non-Core Real Estate is 2.5% and the allocation as of 12/31/2023 is 2.3%. Preliminary Pacing plan for the 2024 vintage is \$70 million committed to 3-4 funds at \$15-20 million per fund. Pending approval of this recommendation, ERSRI’s 2024 vintage commitments will be \$15 million.
- [Rhode Island OPEB System Trust](#): The target allocation for Private Growth is 5.0% and the Non-Core Real Estate sub-strategy is targeted to represent ~20% of the asset class (i.e. 1.0% at the OPEB Trust level). The actual allocation to Private Growth – Non-Core Real Estate as of 12/31/2023 is 0.09%. Preliminary Pacing plan for the 2024 vintage is \$2 million committed to 3-4 funds at \$0.45-0.60 million per fund. Pending approval of this recommendation, OPEB’s 2024 commitments will be \$0.45 million.

### PORTFOLIO FIT:

- [Rhode Island Employees Retirement Systems Pooled Trust](#): The ERSRI Non-Core Real Estate portfolio contains a mix of sector focused and diversified funds that bring operational expertise to value-add and opportunistic asset types (see *Appendix 3*). ERSRI allocates to sector focused funds that demonstrate specialized expertise and differentiated execution. MCR IV targets to have 60-75 hotels, mostly premium branded (e.g., Marriott and Hilton) limited service and extended stay hotels that run an average 75-80%+ occupancy and have high margin rooms business & low overhead expenses (no overhead expenses from full-service Food & Beverage). MCR IV can also invest in full service branded or independent hotels or other hospitality related assets. MCR is a vertically integrated hotel owner operator of nearly 200 hotels. ERSRI’s Non-Core Real portfolio has hotel exposure through diversified funds (not a hotel owner-operator model) and a 2018-vintage hotel focused fund. Pending approval of the recommendation, MCR IV would represent ~4% of the Non-Core Real Estate Portfolio and total hotel exposure through sector focused funds would represent ~9% of the Non-Core Real Estate Portfolio (see *Appendix 4*).
- [Rhode Island OPEB System Trust](#): The Private Growth portfolio allocates to Private Equity and Non-Core Real Estate (as described above) strategies and is ramping up to its target allocation through commitments made in tandem with ERSRI. Pending approval of the recommendation, MCR IV would represent ~9% of Private Growth’s Non-Core Real Estate allocation within OPEB (see *Appendix 5*).

## MERITS:

- **Profitability & Predictability:** Hotel properties are operating business and can deliver higher yields than traditional real estate assets. MCR IV targets a gross IRR of 18-20% (net 15-17%) and a gross equity of 2.0x. About half the return is expected through hotels' operating profits and the remaining half through appreciation. The targeted hotels are similar in nature (premium branded limited service and extended stay hotels) and can be enhanced physically or operationally with a similar approach. Less return surprise (both positive and negative) is expected as targeted hotels are similar in nature.
- **Vertical Integration, Strong Senior & Asset and Operation Management Team:** MCR is an owner and operator. Vertical integration avoids paying potential incentive fees and better aligns interest. In a non-owner-operator model, a 3<sup>rd</sup> party management firm is typically compensated a certain percentage (e.g. 3-4%) of the gross revenue and maybe incentives on net profits. MCR has a senior management team with extensive industry experience and a strong operations management team. Hotels are operating business and driving profits through revenue expansion and cost cutting is the key. Revenue expansion through higher rates and higher occupancy are ultimately through revenue management and better customer service. Cutting costs are achieved through centralizing vendor management (waste management, landscaping company, elevator service provider, etc), some corporate functions through economies of scale such as accounting & IT.
- **Sector Specialist:** MCR is the third largest hotel owner-operator and has about 200 hotels under management. It has received Top Performer Award from Marriott and Hilton multiple times. MCR has been able to deliver a net return about 13% of all investment vehicles since its inception in 2006. Hotels are operating business and if not managed well, hotels are more volatile than other real estate assets. Hotel room nights are perishable; MCR is a sector specialist who aims to improve profits/RevPAR (Revenue per Available Room).

## CONCERNS:

- **ESG Policy:** MCR doesn't have a formal ESG policy, a dedicated ESG team member or an ESG committee.
  - **Mitigant – ESG Goals & Initiatives by Hotel Brands (Marriott/Hilton)** Although without a formal ESG policy, MCR considers energy efficiency and water conservation as part of the acquisition due diligence process. MCR also leans on ESG research and policies established by Hilton and by Marriott. At the property level, MCR implements brand approved ESG programs such as amenity recycling/ bulk amenity and paper, plastic recycling programs.
- **Succession Plan:** MCR doesn't have a formal succession plan for its founder.
  - **Mitigant – Key Person Clause:** Tyler Morse, founder of MCR, is listed as a key person. Commitment period will be automatically suspended if a key person event is triggered. Investors in existing MCR funds have expressed similar concerns and will push for a formal plan.

## ESG: MCR is categorized as an ESG **integrator**.

- **ESG:** MCR doesn't have a formal ESG policy but considers ESG as part of the acquisition due diligence and asset management. Brand ESG Goals & Initiatives are pushing MCR to adopt. Hilton and Marriott publish an annual ESG report tracking environmental impact (energy & emission, water, waste, and etc.) of its own managed hotels and franchised hotels. Hilton and Marriott have suggested and/or set up goals for franchised hotels and are increasing compliance requirements.
- **DEI:** MCR is committed to Diversity, Equity, and Inclusion ("DEI"). Around 40% of all investment professionals are either women or minorities. General managers at MCR hotels are required to participate Diversity Inclusion Training and unconscious bias training.

## FEES: Fees for MCR IV are in-line with industry standards.

- **Management Fees:** MCR IV charges a 1.5% management fee for capital commitment during the 4-year investment period and 1.5% of net invested capital thereafter.
- **Carried Interest:** Carried interest is 20% over an 8% hurdle with a 50% catchup to the GP. Carry is distributed on a total fund basis.

## Appendix 1: ERSRI Prior Fund Exposure

This section is left blank intentionally. ERSRI has no exposure to prior MCR funds.

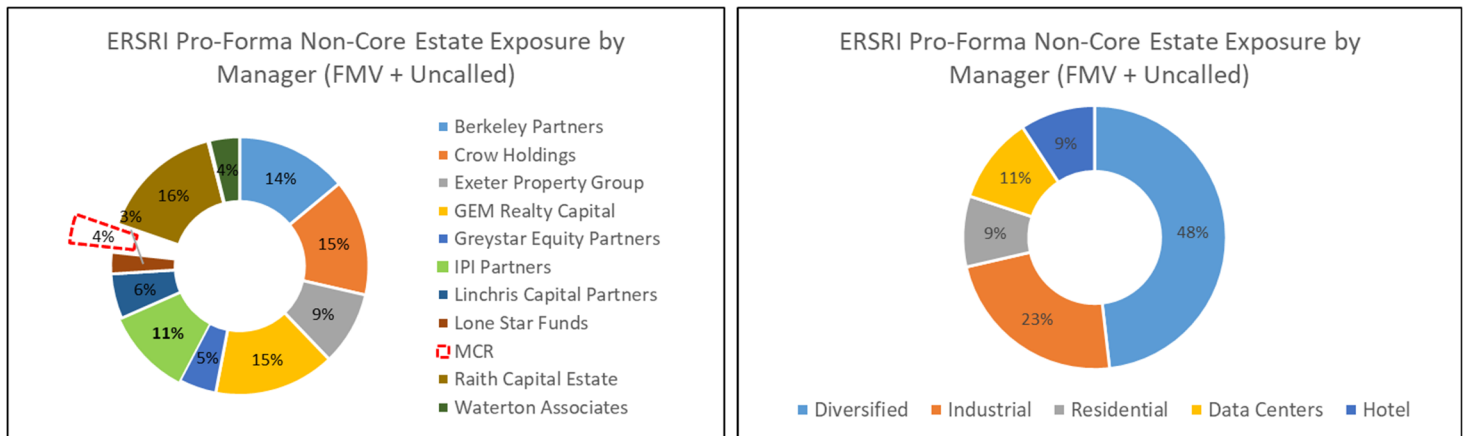
## Appendix 2: ERSRI Prior Fund Performance

This section is left blank intentionally. ERSRI has no exposure to prior MCR funds.

## Appendix 3: ERSRI Non-Core Real Estate Managers

ERSRI Non-Core Real Estate Managers		
Manager	Sub-Strategy	Sector
Crow (Diversified)	Value-Add	Diversified
GEM	Value-Add/Opportunistic	Diversified
Raith	Opportunistic	Diversified
Lone Star	Distressed	Diversified
IC Berkeley	Value-Add	Industrial
Exeter	Value-Add	Industrial
Crow (Retail)	Value-Add	Retail - Food & Service
Waterton	Value-Add	Residential
Greystar	Value-Add	Residential
Linchris	Value-Add	Hotel
MCR	Value-Add	Hotel
IPI	Value-Add/Opportunistic	Data Centers

## Appendix 4: ERSRI Portfolio Fit



## Appendix 5: OPEB Portfolio Fit

