



State of Rhode Island
Office of the General Treasurer

AEW Essential Housing Fund (“EHF”) - Staff Recommendation
February-2022

RECOMMENDATION: Approve an initial investment of \$25 million to AEW Essential Housing Fund

ASSET CLASS: Core Real Estate

SUB-STRATEGY: Residential Affordable Housing

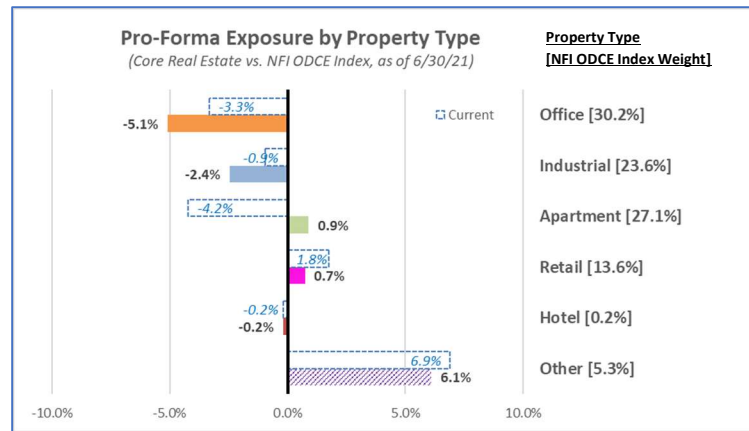
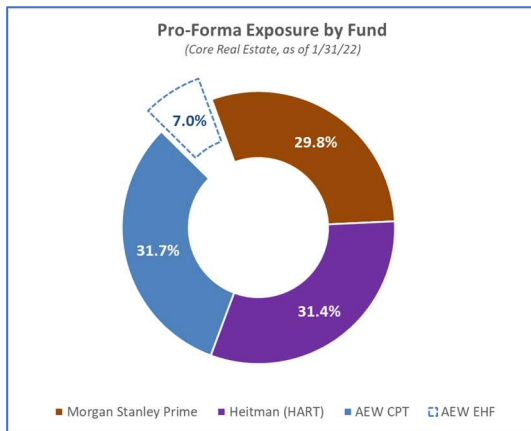
ALLOCATION: The target allocation for Core Real Estate is 4.0%, and the actual allocation as of 1/31/2022 is 3.1%. Effective 7/1/2021, ERSRI’s strategic target to Core Real Estate was increased from 3.6% to 4.0%.

PORTFOLIO FIT: ERSRI’s Core Real Estate allocation resides within the portfolio’s Inflation Protection allocation, which is a subcomponent of the Plan’s Stability Bucket. The Core Real Estate allocation seeks to earn returns through investments in a diversified set of substantially leased income-producing properties. Core properties demonstrate predictable income flows with a high proportion of anticipated total return from tenant rents. Aligned with the broader goals of the allocation, AEW EHF is an income focused vehicle that will seek to generate stable, recession-resilient income derived from higher occupancy, lower than average tenant turnover, controlled expenses, and limited new competitive supply risk, while providing for the preservation of capital and modest levels of appreciation over time. EHF will focus on affordable housing, a subsector of the residential market that has historically exhibited more cycle-resiliency and income stability than the traditional Class-A multi-family segment.

ERSRI’s Core Real Estate allocation is currently comprised of three open-ended core funds, including AEW Core Property Trust (“CPT”), that represent equity ownership in stabilized assets that are highly diversified by property type. ERSRI’s property type exposure is broadly diversified and does not appreciably deviate from the asset class benchmark’s (NFI ODCE Index) sector allocation. AEW EHF is a sector-focused open-ended fund that will concentrate on affordable housing – residential assets that are affordable to low-to-middle income households. Despite the sector focus, an investment in AEW EHF would not significantly impact ERSRI’s benchmark-relative property type exposure at the recommended investment sizing of \$25 million.

Additionally, EHF’s characteristics (target market, resident, and property profile) will further diversify ERSRI’s current apartment/residential exposure. The traditional Open End Diversified Core Equity (ODCE) funds invest higher on the apartment class spectrum, targeting a very different degree of affordability and property profile. A typical property management strategy in the more traditional apartment sector is to try to regularly raise/maximize rental rates to support growing income for an investment. This will be a less emphasized strategy in EHF. AEW EHF will assemble a diversified portfolio of housing assets, primarily targeting: (1) properties that have pre-existing government rent restrictions; (2) naturally occurring affordable housing due to property age, condition, or location; and (3) market rate properties that AEW is able to partner with a local housing authority and voluntarily rent restrict in exchange for economic benefits. These strategies are not materially represented in ERSRI’s current Real Estate portfolio.

A \$25 million investment would not materially increase manager concentration concerns – if approved, AEW would represent ~39% of the Core Real Estate portfolio (AEW currently represents ~34% of the Core Real Estate portfolio).



Pro-Forma includes \$25 million investment in AEW EHF; property type exposure allocated to apartment.

MERITS:

Affordable Housing Market Dynamics – The affordable housing market is defined by a persistent structural imbalance between supply and demand. The Class-A segment of the residential market attracts a disproportionate share of institutional capital and essentially all of the new supply; existing inventory is lost to value-add strategies that target higher-income tenants. The affordable market segment benefits from high occupancy rates, cycle-resilient cash flows, and substantially less (albeit, increasing) institutional competition.

AEW Platform – AEW boasts a 40-year-old global investment platform that exclusively focuses on real estate, currently managing nearly \$90 billion in assets that are diversified by property type and region. The dedicated EHF team will be supported by the broader resources of AEW, including the seasoned ~40 person acquisition team that is able to leverage a well-established network of relationships to identify opportunities, as well as the experienced multi-family asset management team. AEW’s dedicated in-house research division is highly regarded and supports EHF with proprietary data and analytical tools that can help identify investments, assess relative market risks, and analyze submarket and property-level characteristics.

ERSRI/AEW Relationship – ERSRI is a current investor in AEW Core Property Trust, a component of the Plan’s Core Real Estate allocation. Consistent with ERSRI’s broader strategic objectives of consolidating and strengthening partnerships, an investment in AEW EHF gives ERSRI an opportunity to expand its relationship with an existing partner who has successfully executed its mandate on behalf of the Plan for over a decade.

Fund Structure and Economics – AEW EHF is an open-ended vehicle with a flat fee arrangement. This structure is aligned with the nature of the market as well as the objectives of the Core Real Estate allocation and EHF, which focuses on asset preservation and durable cash flow. This structural alignment differentiates EHF from competitor workforce and affordable housing funds that are closed-end and/or charge carried interest. The early investor discounted management fee proposal of 0.65% represents a significant discount to market standard.

Positive Social Externalities – AEW’s strategy promotes the preservation – and increase – of the stock of available affordable housing, a sector facing a national shortage that disproportionately impacts an underserved population. This initiative driven strategy can lead to off-market or early-look sourcing advantages due its alignment with mission-oriented entities such as housing authorities.

RISKS:

Fund I – EHF is AEW’s first dedicated affordable housing fund. This risk is mitigated by AEW’s extensive history in residential/multi-family investing. AEW’s core multi-family investments have consistently outperformed, and they have successfully managed nearly \$5 billion in assets of affordable residential properties (rents affordable to households with less than 80% of the area’s median income). Approximately 40% of these assets were managed with core risk profiles. AEW also has extensive history managing properties with existing rent restrictions.

New Portfolio Manager – The strategy’s PM, Dillon Lorda, is a relatively new addition to AEW having joined the firm in 2020. However, Mr. Lorda brings additional expertise in the affordable housing space. He is fully dedicated to AEW

EHF and has over 20 years' worth of experience in real estate acquisitions and management. The new portfolio manager risk is mitigated by the fact that Mr. Lorda will be supported by a senior management team throughout the entire lifecycle of each investment. The members of the Investment and Risk Management Committees are multidisciplinary and have more than 25 years of real estate experience on average.

Leverage – According to fund guidelines, loan-to-value (“LTV”) cannot exceed 50% of the Fund’s gross asset value. While significantly lower than the amount of leverage employed by value-add and opportunistic real estate funds, 50% LTV would give AEW EHF the highest leverage of the funds in ERSRI’s Core Real Estate portfolio. This risk is mitigated by the small relative investment size. At \$25mm, AEW EHF would not materially increase the Core Real Estate portfolio’s weighted average LTV. Additionally, affordable housing is a market segment that is relatively well-suited for moderate leverage given the high and stable cash flow.

ESG: AEW is categorized as an ESG **Integrator**. AEW has established a Socially Responsible Investment policy and ESG is systematically incorporated into the decision-making process throughout the life of each investment. A specific ESG+R assessment is completed by a third-party consultant, in addition to a property condition assessment and energy audit during the due diligence process. AEW has an ESG+R Steering Committee which is comprised of the most senior professionals across the firm's various business units and departments. In January of 2022, AEW hired a Chief Sustainability Officer, a newly created position within the organization. The role will work closely with the members of the firm’s ESG+R Committee in implementing and overseeing the firm’s ESG+R program including the firm’s initiatives on climate change. While AEW does not currently capture specific diversity metrics from its vendors, the firm has recently begun to track and manage a database of Minority and Women-Owned third-party service providers and businesses it partners with.

FEES: AEW is proposing a lifetime discounted management fee for early investors (0.65% for ERSRI). This proposal represents a substantial discount to the standard 1.25% management fee that will be charged for sub-\$50 million commitments. AEW EHF will not charge a performance fee.