



COMMONWEALTH OF PENNSYLVANIA  
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

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Public Investment Memorandum

**Cabot Industrial Core Fund II, L.P.**

Real Estate Commitment

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**William P. Stalter**  
Senior Portfolio Manager

**February 7, 2018**



### **Recommendation:**

Staff, together with Courtland Partners, Ltd, recommends the Board commit up to \$100 million to Cabot Industrial Core Fund II L.P. ("Fund" or "Core II"). Cabot Properties ("Cabot" or the "Firm") seeks to provide superior risk-adjusted real estate returns by investing in core industrial properties, located in the United States. Cabot will exercise its proven investment strategy of: (i) focusing exclusively on the industrial sector; (ii) targeting markets with growing demand and scarcity value; (iii) underwriting with disciplined attention to value; (iv) creating value through active management and (v) adeptly evaluating and executing dispositions.

### **Firm Overview:**

Cabot Properties ("Cabot") is a private equity real estate firm based in Boston, MA. The firm is a leading investor, developer, and operator of industrial properties. Formed in 1986, Cabot was founded with the vision of bringing together a collaborative team of experienced real estate professionals dedicated to creating portfolios of profitable investments through the execution of a sound and disciplined strategy. Its six senior principals have collectively spent 16 years together.

Over its 31-year history as an industrial property specialist, Cabot has managed both core and value-add investments programs. Through these years, Cabot has invested \$8.2 billion in industrial real estate, managing and operating 165 million sq. ft. with over 3,600 tenants. As of September 30, 2017, current assets under management include 192 buildings totaling 32 million sq. ft. in 23 markets across North America and the U.K.

### **Market Opportunity:**

Over the past 20 years, industrial properties have not only produced attractive returns, but also the highest ratio of current income of all major property types, according to NCREIF data. These properties benefit from favorable lease structures, minimal property level expenses and low volatility. Industrial leases often contain built in rental increases, supporting income growth over time. Industrial properties are also less costly to operate and own than other asset classes. Many leases are triple net, with all operating expenses being the responsibility of the tenant, while the simple design of industrial buildings generally requires lower capital expenditures and tenant-specific improvements.

The industrial sector is also characterized by a low level of volatility compared to other sectors. Relatively stable supply-demand dynamics and long leases have resulted in consistently low levels of vacancy through varying market cycles. Since 1990, U.S. industrial vacancies have ranged from a low of 4.9% (2017) to a high of 10% (2010), averaging 7.2%. In comparison, U.S. office space vacancy rates have ranged from 6.4% (2000) to 13.8% (1991), averaging 11.0%. U.S. industrial properties have historically generally provided attractive risk-adjusted returns.

eCommerce is now an established presence in the retail landscape and a critical new driver of demand for logistics real estate. Averaging just under 20% annual growth since 2000, eCommerce totaled over \$300 billion in sales in 2016 and accounts for around 35% of all goods that can typically be purchased online (excluding restaurants, gasoline, and auto) in the U.S. over the next few years. With retailers increasingly shipping directly to consumers, traditional distribution networks are being disrupted and inventory is shifting from retail to warehouse locations.

As proximity to consumers and delivery times increase in importance, supply chain reconfiguration is occurring across the retail landscape. Instead of primarily large fulfillment centers in national locations, smaller regional and local distribution facilities are required close to major populations as well as FedEx and UPS centers. Further, operational requirements of eCommerce tenants have stimulated advances in logistics and inventory management, resulting in an emphasis on building standards. Attributes such as higher clear heights, wider column spacing, efficient systems and ample employee parking are increasingly in demand. Both trends, prime locations and modern buildings, highlight essential aspects of the Core II strategy and provide sustainable long-term demand growth for the sector.



**Portfolio Fit:**

A commitment to the Fund 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 22.7% Core, 43.3% Opportunistic, and 34.0% Value-Added.

The table below summarizes PSERS' projected exposure inclusive of a recommended \$100 million commitment to the Fund, as of September 30, 2017:

Investment Type (\$M)	Market Value <sup>(1)</sup>	%	Unfunded	%	Total Exposure <sup>(1)</sup>	%	Long Term Target (%)
Core	1,702.6	27.5%	270.3	10.8%	1,972.9	22.7%	20%
Opportunistic	2,813.2	45.5%	947.7	37.8%	3,760.9	43.3%	30%
Value-Add	1,670.1	27.0%	1,288.7	51.4%	2,958.8	34.0%	50%
<b>Total</b>	<b>\$ 6,186.0</b>	<b>100%</b>	<b>\$ 2,506.7</b>	<b>100%</b>	<b>\$ 8,692.6</b>	<b>100%</b>	<b>100%</b>

<sup>(1)</sup> Includes Gross PTRES Exposure

**Investment Strategy:**

The Fund strategy will focus on accretive acquisitions of stabilized Class A distribution buildings in 12 core industrial markets in the United States. Targeted investments are stable in nature, tend to require limited capital expenditures, and will typically be fully or close to fully leased. It is expected that the Fund will distribute approximately 5% annually from income.

The Fund will target modern, bulk and multi-tenant distribution buildings, which have efficient configurations and property features modern distribution tenants require. The Fund will target investments that meet minimum lease term requirements at acquisition. This requirement is intended to ensure a stable income stream in the near term and also offer the opportunity to grow rents in certain situations over time.

The Fund will be invested based on the following investment themes:

Theme	Description
<b>Markets with Growing Demand</b>	Primary focus on major industrial markets, and their submarkets, with characteristics including: (i) limitations on type and quantity of new development, (ii) proximity and access to labor, amenities, highways, railroads, airports and seaports, (iii) strong job growth and tenant demand, and (iv) market liquidity driven by amount of existing space, tenants and investor interest.
<b>High Quality Buildings with Proven Desirability</b>	The Fund will target modern distribution buildings that are both functional and flexible for many types of users. Cabot's core strategy pursues newer buildings with a minimum clear height standard, proper building depth, sufficient column spacing, and high dock-door ratio relative to the building size. Lighting and life safety systems should meet the latest industry standards. These are the types of buildings in demand from traditional distribution users as well as the growing field of eCommerce tenants that often require first-class building features.
<b>Provide Attractive Income Return</b>	Industrial properties have low ongoing capital requirements, and the tenants pay all expenses related to the properties. Once favorable lease structures are implemented, such as fixed increases over the term, and accretive leverage is applied (less than 40% Fund level), income is increased and distributed quarterly.
<b>Realize Returns</b>	Continually re-evaluate individual exit strategies for each investment and liquidate if the value has peaked and the future contributions to returns are nominal. Consider capital flows within the broader markets to determine if a portfolio premium may be achieved. Shift focus from acquisition to disposition efforts among markets as underlying characteristics evolve.



**Investment Structure:**

The Fund is a Boston-based Delaware Limited Partnership. The General Partner is Cabot Industrial Core Fund II Manager, a Massachusetts Limited Partnership.

The Fund's sponsor, Cabot Properties, L.P., was formed in 2001 as a Delaware Limited Partnership and is registered as an investment adviser with the SEC. The firm is an employee-owned private partnership.

**Investment Instruments:**

Investments by the Fund will be comprised of interests in real estate properties, which may be made through one of more real estate investment trusts or other subsidiary entities to maximize tax efficiency.

**Investment Team:**

Cabot headquartered is in Boston, with one additional office on London, UK. Cabot has 41 employees, of which there are 11 investment professionals and 6 partners. The investment team is led by six senior principals, who collectively have spent 16 years working together at Cabot. The investment committee for the Fund is comprised of Franz F. Colloredo-Mansfeld, Howard B. Hodgson, Jr., Mark A. Bechard, Charles L. Forbes, Patrick V. Ryan, and Stephen P. Vallarelli, who have an average of 20 years of industrial real estate experience at Cabot.

The Cabot team compensation is significantly incentive-oriented, with a majority of the firm's investment professionals participating in the GP co-investment and the carry of the funds. All of the employees are fully dedicated to the core and value-added fund series, as there are not any other lines of business within Cabot.

**Investment Highlights:**

<b>Longevity and experience of the Cabot firm and team</b>
Cabot's experienced and cohesive team has been focused on the industrial arena for over 30 years and has demonstrated the ability to capitalize on their large network of national relationships as well as their broad local market relationships.
<b>Strong Tenant Demand and Favorable Market Conditions</b>
The operating fundamentals in the industrial sector are attractive. Rents have been recovering since the financial crisis but are still below peak levels on an inflation-adjusted basis. Continuing strong U.S. economic performance and structural factors including the expansion of eCommerce and supply chain reconfiguration should continue to drive demand for high quality industrial space in prime locations.
<b>Demonstrated Ability to Capture Premiums on Dispositions</b>
Cabot has been an active harvester of value, selling assets ranging from single properties to large portfolios such as the \$2.1 billion sale of the Cabot REIT. The management team will be focused on realizing investment returns for the Fund, and will carefully evaluate all investment, financing and portfolio management decisions relative to this objective. Given the lack of large, high-quality industrial portfolios available, the Fund may have the opportunity to aggregate single assets into portfolios that can be sold at premium prices. Cabot has also achieved attractive prices by selling single properties on an opportunistic basis to tax motivated users and other local investors.



**Investment / Risk Considerations:**

<b>Competition in the Industrial Market</b>
Other properties will compete with the Fund's industrial properties in attracting tenants, including other industrial and similar properties that are available for rent in the relevant market. If the demand for industrial rental properties is reduced, or if competitors develop and/or acquire competing properties on a more cost-effective basis, rental rates may drop, which may have a material adverse effect on the income generated from the Fund's investments and their underlying value.
<b>Reliance on Local/Regional Property Management and Leasing</b>
Although Cabot outsources property management and leasing, their hands-on approach to asset management focuses on close relationships with tenants, stringent budgetary controls, and careful oversight of third-party leasing and management agents. Superior property management is an essential tenant service, and regular tenant communication increases the likelihood that tenants will perform under lease obligations and greatly enhances tenant retention. Cabot focuses its asset management on tenant retention, and on improvements that will have a direct impact on rental rates. While Cabot pursues the more cost effective, direct lease renewals, they typically list all vacant space through leading local leasing broker relationships, which can provide them with access to new investment opportunities.

**PSERS History & Performance:**

PSERS relationship with Cabot began in 1998, when PSERS' directly held industrial properties, valued at \$110 million, were exchanged for 5.5 million shares of the public Cabot REIT. The shares were tendered in 2001 for a gain of \$22 million and a net IRR of 11.3%. The following table summarizes PSERS' historical performance with Cabot, as of September 30, 2017:

Fund (\$M)	Vintage	Fund Size	Commitment	Contributions	Distributions	NAV	Net IRR	MoC
Cabot Industrial Core Fund, L.P.	2015	443.0	150.0	145.6	5.7	151.7	10.9	1.1
Cabot Industrial Value Fund III, L.P.	2008	679.6	100.0	81.7	123.2	N/A	21.9	1.5
Cabot Industrial Value Fund IV, L.P.	2013	712.0	75.0	72.7	13.8	74.9	14.4	1.2
Cabot Industrial Value Fund V, L.P.	2016	775.0	100.0	-	-	N/A	N/A	N/A
<b>Total</b>			<b>\$ 425.0</b>	<b>\$ 300.0</b>	<b>\$ 142.8</b>	<b>\$ 226.6</b>	<b>18.8%</b>	<b>1.2x</b>

**Finance Committee Disclosure:**

<b>Relationship with Courtland Partners, Ltd:</b>	None Disclosed
<b>Introduction Source:</b>	Fund Sponsor
<b>Placement Agent:</b>	No
<b>PA Political Contributions:</b>	None Disclosed
<b>PA Presence:</b>	Across several Cabot-sponsored funds, PSERS has exposure to 21 industrial properties (1.2M SF / \$11.8M PSERS pro rata of market value). These assets are located in Glen Rock, Upper Chichester, Mechanicsburg, Hatfield, West Chester, Exton and Allentown.
<b>Potential Conflicts:</b>	We are not aware of Cabot having any investment conflicts.
<b>First Time Fund With PSERS:</b>	No
<b>PSERS Allocation Implementation Committee Approval:</b>	February 7, 2018

**Oversight Responsibility:**

<b>Investment Office:</b>	Charles J. Spiller William P. Stalter	Deputy CIO, Non-Traditional Investments Senior Portfolio Manager
<b>External Consultant:</b>	Courtland Partners, Ltd.	

# COURTLAND PARTNERS, LTD.

## INSTITUTIONAL REAL ESTATE SERVICES

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February 1, 2018

Board of Trustees  
Commonwealth of Pennsylvania,  
Public School Employees' Retirement System  
5 North 5<sup>th</sup> Street  
Harrisburg, PA 17101

**Re: Cabot Industrial Core Fund II L.P.**

Dear Trustees:

Courtland Partners, Ltd. ("Courtland"), having been duly authorized by the Board of PSERS, has evaluated the Cabot Industrial Core Fund II L.P., ("the Fund"). The Fund will focus exclusively on the industrial sector, targeting a limited number of select markets with growing demand and asset scarcity. Underwriting will focus on minimizing risk and maintaining value through active management and providing attractive current income. Consistent with the tactics it has employed over time, Cabot will generally pursue transactions smaller than \$50 million and will seek to assemble portfolios for future sales at premium prices. The portfolio is generally expected to consist of 80 to 120 buildings totaling 17 to 20 million square feet. The Fund will target modern distribution buildings, between 100,000 and 500,000 sf, that are both functional and flexible for many types of users. Cabot's core strategy pursues newer buildings generally constructed after 2000, with a minimum clear height of 24 feet. There is a 10% non-industrial carve-out. This provides some flexibility if there is a non-industrial use in what would otherwise be an industrial building. Some tenants use a portion of their warehouse space for office or retail portions.

The Fund is targeting net returns of 8-10%; with anticipated initial current yields of 5-6% which would grow over the duration of the fund. As a result, 70-80% of the return is expected to be from current income with the balance of the return resulting from appreciation driven by the growth in income. Although Cabot has been successful in achieving portfolio premiums, this is an additional source of potential return that is not assumed in its underwriting. Core opportunities, including core industrial opportunities, have become more competitive. The most expensive core industrial opportunities tend to be portfolios that are \$100 million or more in size. There is less competition, from the traditional core investors (such as the open-ended core funds and the large pension advisors) for single property investment opportunities. Historically, Cabot has been able to source these opportunities from tenants, smaller non-institutional owners, and smaller institutions. This approach helps Cabot to avoid over-paying for assets. Cabot is a disciplined investor and closes on a small portion of the opportunities under review.

The majority of assets will be high quality industrial properties that can accommodate single tenants and multiple tenants. Cabot anticipates that single tenant buildings will be 30% to 50% of the portfolio. Tenant size may average 200,000 square feet.

Cabot has several distinct advantages as far as generating proprietary deal flow. Cabot has been in business, focused exclusively on industrial properties, for 25 years. Since 1998, Cabot has completed

over 350 industrial (primarily value add) transactions with a wide range of brokers. The industrial brokerage community knows Cabot. Cabot has also sourced properties directly from sellers and made hundreds of unsolicited offers. Cabot is known as being easy to deal with because they close so many smaller transactions. Cabot has an efficient due diligence process and since they buy on an “all cash” basis, there is not a need to obtain financing. While Cabot may not be the highest bidder, Cabot professionals are known to do what they say they are going to do (such as closing by a certain date). Brokers and sellers appreciate that surety, which leads to repeat business and the first (or last) call on many transactions.

Courtland’s recommendation is based upon the following factors and is made within the context of PSERS’ investment guidelines.

- Detailed due diligence with key Cabot management team members, and review of all relevant materials provided by Cabot.
- Evaluation of the Fund’s proposed investment strategy within the context of the current investment environment.
- Evaluation of Cabot’s track record and organizational resources.
- Discussion and review of the market conditions in markets relative to the proposed investment strategy.
- The strategy proposed for the Fund is appropriate for the real estate component of the portfolio.

Based on the above factors, Courtland recommends that PSERS commit up to \$100 million to the Fund. Courtland makes this recommendation considering Cabot’s qualifications and PSERS’ overall investment guidelines.

This recommendation is given solely for the benefit of PSERS and cannot be relied upon by other investors considering an investment in the Fund, since their needs, objectives and circumstances may not be identical to those of PSERS. The scope of this recommendation is limited to the investment merits of the Fund. Courtland does not provide legal or other non-investment-related advice.

Sincerely,



Steven Novick  
Principal-Chief Operating Officer

**COURTLAND PARTNERS, LTD.**