



State of New Jersey

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May 19, 2017

MEMORANDUM TO: The State Investment Council

FROM: Christopher McDonough
Director

SUBJECT: **Proposed Investment in Hammes Partners III, L.P.**

The New Jersey Division of Investment (“Division”) is proposing an investment of up to \$50 million in Hammes Partners III, L.P. (“Fund”). This memorandum is presented to the State Investment Council (the “Council”) pursuant to N.J.A.C. 17:16-69.9.

The Fund will have a substantially similar investment strategy to previous Hammes funds, focusing on the acquisition and development of medical office buildings and ambulatory care centers across the United States. Hammes plans to acquire existing assets directly from healthcare providers and develop new assets to be occupied predominantly by said healthcare providers.

The Division is recommending this investment based on the following factors:

Experienced Management Team: Hammes’ senior management team has over 29-years average experience and has been involved in over 750 healthcare facilities.

Unique Nationwide Platform: Hammes has proprietary sourcing capabilities through an affiliated advisory firm and through an affiliated property services firm which manages over 3 million square feet of healthcare assets.

Market Opportunity: An aging population and increased healthcare spending support need for healthcare services. Industry cost pressure, consolidation and modernization needs emphasize the need for quality healthcare real estate. Favorable tenant characteristics and lease structures provide stable cash flow and higher return from current cash.

Track Record of Strong Performance: As of December 31, 2016, the net returns for Fund I are 20.6% Internal Rate of Return (“IRR”) and 2.4x Multiple on Invested Capital (“MOIC”), making it a top quartile fund based on Preqin’s Quartile Rankings. Fund II is projected to have net returns

of 11.5% IRR and 2.0x MOIC, and is generating a current return of 10.5% on assets held more than 12 months.

Significant Alignment of Interest: The General Partner will make a significant equity investment of 2% of the fund or up to \$12 million. The Fund will have a fully pooled carry. The manager will have no competing mandates.

Portfolio Fit: The Division's real estate portfolio is significantly underweight in office space at 26.5% compared with 37.7% for the NCREIF ODCE index. Medical office has outperformed traditional office by 200 basis points over the past cycle. The vacancy rate for medical office assets is 8.5% compared to 11.8% for traditional office properties.

A report of the Investment Policy Committee ("IPC") summarizing the details of the proposed investment is attached.

Division Staff and its real estate consultant, RVK, Inc., undertook extensive due diligence on the proposed investment in accordance with the Division's Alternative Investment Due Diligence Procedures.

The Fund utilized Probitas Funds Group, LLC (the "placement agent") as third-party solicitor in connection with the potential investment. Staff has determined that the placement agent and its representatives met the registration, licensing and experience requirements set forth in the Division's Placement Agent Policy (the "Policy"). Pursuant to the Policy, the Fund has disclosed the contract between the Fund and the placement agent, specifying the scope of services to be performed by the placement agent and the fee arrangement between the placement agent, the general partner and any other third party.

We will work with representatives of the Division of Law and outside counsel to review and negotiate specific terms of the legal documents to govern the investment. We have obtained a preliminary Disclosure Report of Political Contributions in accordance with the Council's regulation governing political contributions (N.J.A.C. 17:16-4) and no political contributions have been disclosed. We will obtain an updated Disclosure Report at the time of closing.

Please note that the investment is authorized pursuant to Articles 69 and 71 of the Council's regulations. Hammes Partners III, L.P. will be considered a non-core real estate investment, as defined under N.J.A.C. 17:16-71.1.

A formal written due diligence report for the proposed investment was sent to each member of the IPC; a meeting of the IPC was held on January 12, 2017 and an update was provided to the IPC on May 12, 2017. In addition to the formal written due diligence report, all other information obtained by the Division on the investment was made available to the IPC.

We look forward to discussing the proposed investment at the Council's May 24, 2017 meeting.

Attachments

Fund Name: Hammes Partners III, L.P.

May 19, 2017

Contact Info: Patrick Hammes, 18000 West Sarah Lane, Suite 250, Brookfield, WI 53045

Fund Details:

| | | |
|---------------------------|------------------------|--|
| Total Firm Assets: | \$1.1 billion | Key Investment Professionals: Jon Hammes, Founder and Managing Partner of Hammes Realty Advisors ("HRA"), and a member of the investment committee. Mr. Hammes is also Managing Partner of Hammes Company Health Care ("HCHC"). Hammes Company, through HCHC and Hammes Realty Services ("HRS"), is a nationally recognized leader in the development, financing, and management of strategic real estate assets, specifically in the healthcare industry. Prior to forming Hammes in 1991, he was a Managing Partner at Trammell Crow. Todd Kibler, Principal, Investments & Financing of HRA. Mr. Kibler was formerly Senior Vice President of Finance & Investments and Chief Financial Officer for HCHC. He is now devoted to acquisition and development transactions for the Fund and is a member of the investment committee. Patrick Hammes, Principal, Operations and Portfolio Management of HRA. Mr. Hammes is a member of the investment committee. Prior to his role with Hammes, he was a Vice President in the Business Services and Healthcare Investment Banking Group at Robert W. Baird & Co. |
| Strategy: | Non-core real estate | |
| Year Founded: | 1991 | |
| Headquarters: | Brookfield, WI | |
| GP Commitment: | 2%, up to \$12 million | |

Investment Summary

The Fund will have a substantially similar investment strategy to Hammes II, focusing on the acquisition and development of medical office buildings ("MOBs") and ambulatory care centers ("ACCs") across the United States. Hammes plans to acquire existing assets directly from healthcare providers and develop new assets to be occupied predominantly by said healthcare providers, though the Fund is precluded from investing in ground-up "speculative" developments (i.e., less than 50% pre-leased). The Fund is limited to no more than 35% of commitments in a single Metropolitan Statistical Area ("MSA") and no more than 30% to the credit exposure of a single healthcare provider.

Existing and Prior Funds

| <u>Funds</u> | <u>Vintage Year</u> | <u>Strategy</u> | <u>Returns as of 12/31/2016*</u> |
|--------------|---------------------|-----------------|--|
| Fund I | 2001 | Non-core | 20.6% Net IRR; 2.4x Net MOIC; 168% DPI |
| Fund II | 2015 | Non-core | 10.0% Net IRR; 1.1x Net MOIC; 9.3% DPI |

IRR = Internal Rate of Return; MOIC= Multiple on Invested Capital; DPI = Distributions to Paid-In
* Returns provided by the General Partner

Vehicle Information:

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|--------------------------|---------------|-----------------------|-----------------------------|
| Inception: | 2017 | Auditor: | PricewaterhouseCoopers LLP |
| Fund Size : | \$600 million | Legal Counsel: | Gibson, Dunn & Crutcher LLP |
| Management Fee: | 1.40% | | |
| Carry: | 20% | | |
| Preferred Return: | 8% | | |

NJ AIP Program

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|--------------------------------|--------------------|---|-----|
| Recommended Allocation: | Up to \$50 million | LP Advisory Board Membership: | TBD |
| % of Fund: | 8.33% | Consultant Recommendation: | Yes |
| | | Placement Agent: | Yes |
| | | Compliance w/ Division Placement Agent Policy: | Yes |
| | | Compliance w/ SIC Political Contribution Reg: | Yes |

*This review memorandum was prepared in accordance with the State Investment Council rules governing the Alternatives Investment Program and the policies and procedures related thereto.