



To: Ventura County Employees' Retirement Association

From: NEPC Consulting team

Date: September 30, 2024

Subject: Sculptor Real Estate Fund V – Recommendation to Commit \$100M

Recommendation

NEPC supports VCERA staff's recommendation that the Board of the Ventura County Employees' Retirement Association ("VCERA" or the "Plan") approve a commitment of \$100 million to Sculptor Real Estate Fund V (the "Fund" or "Fund V"). The Fund has been rated "1" by the NEPC Private Investment Committee, indicating high conviction in this product.

NEPC and VCERA's CIO believe that the Sculptor Real Estate Fund V fits well in the Plan's portfolio for the following reasons:

- **Strong and Consistent Track Record Across Cycles:** Since the launch of Sculptor Real Estate ("SRE") in 2003, the Firm has raised and deployed four prior funds in the flagship series. The first three vintages are in the top quartile (on an IRR basis) versus peers in the Cambridge Associates Global Opportunistic Closed-End Real Estate Universe, generating net IRRs of 16.1%, 21.6%, and 20.0%, respectively, as of March 31, 2024. Fund IV is currently ranked in the second quartile with a 13.0% net IRR, though it is still in the final stages of its investment period and too early in its lifecycle to draw significant conclusions. Sculptor has also shown the ability to outperform across various market cycles. Fund I was a 2005 vintage fund invested in the lead up to the Global Financial Crisis. Sculptor was able to exit its GDP sensitive assets like hotels and rotate into less correlated non-traditional property sectors like gaming, allowing Fund I to realize a 16.1% IRR in a market environment when the median fund earned a 3.7% net IRR. Fund II was a 2010 vintage and showed Sculptor's ability to be nimble in the face of a changed market environment. Given distressed and depressed valuations across the investment landscape at that time, Sculptor pivoted more into equity positions in traditional property sectors and posted a first quartile IRR that again finished 10% higher than the median peer fund.
- **Flexible Approach to Investment Structures with Relatively Low Leverage:** Sculptor is agnostic to its place in the capital structure on a given investment if it is able underwrite an investment that meets or exceeds its target return and provides an appropriate risk-adjusted return. In Fund II, Sculptor leaned into common equity positions in the wake of depressed asset values following the Global Financial Crisis, while Fund IV (2019 vintage), which was invested during the peak asset values of 2020 and 2021 then during the interest rate hike and market dislocation that followed, was geared more towards debt and structured equity positions, with a weighted average leverage of 35% across the fund. Sculptor expects Fund V to have a balanced approach with a roughly even mix of common equity and debt or structured equity positions. In addition to Sculptor's conservative approach to capital structure, the Fund will also take on minimal debt financing, with the Fund expected to have an LTV of 35% to 50%, similar to all prior Fund vintages. Other opportunistic real estate equity funds often target 60% to 70% LTV, and in the current elevated interest rate environment, Sculptor may benefit from less reliance than peers on leverage to achieve target returns.

- **Experienced and Tenured Investment Team:** Sculptor Real Estate is led by Steven Orbuch, who created the SRE platform 20 years ago and has significant real estate investing experience dating back to his time at Blackstone. Steven Orbuch has built a tenured team, with four additional executive managing directors that have all been with the Firm for over 20 years and have experience investing together through multiple market cycles. Each senior investment professional has coverage of a specific set of property sectors and are also tasked with researching new themes that may be investable for the Fund going forward. The team has demonstrated its ability to evolve its investment ideas and uncover mispriced opportunities, as evidenced by the Fund series track record. The Manager tends to have an analyst entry point and then will develop and elevate their investment talent.
- **Experience Investing in Non-Traditional Property Sectors:** The Sculptor team will invest in a variety of non-core real estate property sectors including more niche property sectors than other real estate investment managers, thereby limiting capital markets competition. Strong and longstanding relationships with specialized operating partners has helped the team invest successfully in gaming, lodging, and seniors housing opportunities, among others. Sculptor believes these non-traditional property sectors are often misunderstood by other institutional real estate investors, allowing for inefficient markets that can provide outsized returns. Sculptor also contends that many of its investments will be largely uncorrelated to GDP growth, which should help insulate the portfolio in changing market environments, particularly with the Fund's higher cash yield focus.

Overview of VCERA Private Real Estate Program

As of June 30, 2024, the Real Estate portfolio comprises 5.9% of the total fund versus its target allocation of 8%. VCERA has committed \$245 million to Private Real Estate with approximately \$115 million invested.

Through March 31, 2024, the Private Real Estate allocation has generated a net internal rate of return ("IRR") of 7.8% per annum with a Total Value to Paid-In Capital ("TVPI") ratio of 1.12x.

Fund Overview

Sculptor is raising \$3.0 billion for Sculptor Real Estate Fund V (the "Fund," or "Fund V"). Fund V will focus on middle-market opportunities (\$25 million to \$75 million of equity) in the United States and Europe. As it has done in its prior funds, Sculptor will invest the majority of Fund V capital in niche property types such as gaming, cell towers, resorts, and car washes, while selectively pursuing opportunities in traditional property sectors (multifamily, retail, office, industrial and hotel). Sculptor believes that the flexible mandate has allowed them to create diversified and resilient portfolios, relative to peers investing in traditional property types. The Fund can invest across a range of structures and security types, including individual real estate assets, multi-property portfolios or loan pools, operating companies, and structured investments including real estate senior and subordinate real estate debt and preferred equity. The Sculptor team remains keenly focused on current cash yield, generally investing in opportunities where 50% of the total return is generated from the income of an asset. The Fund is targeting a 14% to 18% net IRR and a 1.7x to 1.8x net equity multiple or TVPI.

Sculptor will maintain a situationally opportunistic approach to investment selection rather than trying to invest behind macroeconomic themes. Sculptor believes that other opportunistic real estate managers often chase higher returns by pursuing investments in competitive and growth-oriented sectors and then applying significant leverage, leaving them particularly vulnerable to broader market dynamics. Prior Sculptor funds have had loan-to-value ("LTV") levels ranging from 33% to 49%, with the Manager expecting Fund V to be in the middle of this range. Sector selection is expected to be heavily diversified. Fund IV invested across 19 property sectors, with the six largest



sector weights totaling 60% of the portfolio. Fund V is expected to have a similar property sector distribution. Also well diversified is Sculptor's position in the capital stack. Fund V will invest in equity, debt, and hybrid/structured investment positions. The Manager currently projects Fund V to invest about 50% of Fund commitments in equity investments and the other 50% in debt or structured investment positions, but the approach will be flexible as opportunities arise. Approximately 70% of investments are expected to be in non-traditional property sectors, and 80% are expected to be in North America (mostly the U.S.), with the remaining 20% invested in Europe.

Sculptor Capital Management is a global institutional asset manager with \$32 billion of assets under management ("AUM") as of March 31, 2024, across credit (\$20 billion), multi-strategy (\$8 billion), and real estate (\$4 billion). The Firm was founded in 1994 by Dan Och in partnership with Ziff Brothers Investments. Sculptor has over 300 employees worldwide with offices in New York, London, Hong Kong, Mumbai and Shanghai. The Firm's client base is largely institutional, and includes endowments, foundations, pensions, and insurance companies. The Firm rebranded in August 2019 from Och-Ziff Capital Management to Sculptor Capital Management.

Following an acquisition that was finalized in November 2023, Sculptor Capital Management became a wholly owned subsidiary of Rithm Capital Corp. ("Rithm"), a publicly traded global asset manager focused on real estate, credit and financial services and mortgage servicing REIT (NYSE: RITM). Rithm had \$32 billion of assets as of June 30, 2024. Sculptor has no overlapping business lines with Rithm and operates independently.

Sculptor's real estate team was founded in 2003 by Steven Orbuch, who was previously a senior investment professional at The Blackstone Group. Since the group's founding, it has raised four prior funds in its flagship series (Fund I – 2005 - \$408 million, Fund II -2010 - \$840 million, Fund III – 2014 - \$1.5 billion, and Fund IV – 2020 - \$2.6 billion). The team also manages a credit strategy, which focuses on more senior securities than Fund V, and a recently launched core plus non-traded REIT, which focuses on stabilized cash flowing assets. Neither of these strategies are expected to have much overlap with Fund V, though in the event there was a conflict Fund V would have priority per the Firm's allocation policy. Sculptor currently has 37 professionals working on the Fund that are located in New York and London.

Sculptor Real Estate's track record within the flagship series has consistently delivered within or above the target return range with a strong cash on-cash yield. The high level of portfolio diversification, relationship-driven approach, rigorous investment process, low leverage, and more limited competition has resulted in strong investment performance across cycles since 2005. Although Sculptor has had its share of headline risk emanating from disputes with its founder Dan Och, the acquisition of the Firm by Rithm in November 2023 has resolved any past disputes and positioned the Firm well for future growth.

Portfolio Fit

Given the large allocation that Sculptor will have to non-traditional property sectors, this allocation provides diversification away from traditional property types, with a more opportunistic versus thematic approach. Alongside VCERA's existing commitments to value-add and opportunistic real estate strategies, Fund V would complement the core real estate exposure which comprises the bulk of VCERA's real estate program.

This strategy is a good fit for investors seeking a higher target IRR, while also satisfying investors who seek income returns from their real estate allocation, as 50% of the total return projected to come from cash flow yield from equity and credit positions, benefitting investors who wish to diversify their real estate portfolio across the capital stack.



Potential Concerns

- **Firm Ownership and Recent Changes:** In November 2023, Sculptor Capital Management completed an agreement to be purchased by Rithm Capital, becoming a wholly owned subsidiary. Sculptor was attracted to Rithm in part because the two firms did not have overlapping business lines, and Sculptor wished to remain autonomous in its day-to-day operations. To date, while the relationship has worked as Sculptor hoped, the arrangement is still relatively new, and it remains to be seen how the relationship will develop over time for Rithm given less clear synergies from the acquiror due to its primary business as a mortgage servicing REIT and limited intended involvement, other than expanding into other areas of asset management. No one at Sculptor has any ownership shares of Rithm, stock options, or phantom shares. Instead, the Sculptor team opted for a higher carried interest sharing arrangement, which provides greater Fund alignment of interests but does not reinforce and ties with the parent company.
- **Inherent Risk of Non-Traditional Property Types:** Non-traditional real estate property sectors, such as gaming assets or cell towers, can be riskier than traditional property types, due to generally higher underwriting risks and lower exit liquidity. Assets in these niche property sectors often have a more limited buyer pool and can have more operational risk. Sculptor has historically mitigated these risks by underwriting not only the acquisition and asset management, but also the exit strategy. Sculptor has been able to exit non-core assets by thoughtfully assembling portfolios with attractive risk/return characteristics that appeal to many different types of eventual buyers. Sculptor will thoughtfully enter a niche property sector after doing extensive research and a white paper on the investment thesis. To execute, they will partner with an experienced real estate operator in the non-traditional sector that has operational and investment experience. Given Sculptor has been investing in most of these sectors through the Fund series, the Firm has developed its own specialized investment expertise with senior investment professionals specializing in one to three property sectors. Sculptor further mitigates the inherent risk by focusing primarily on less risky stabilized assets or investing through a debt or preferred equity structure.
- **Potential for Slower Deployment and Fund Liquidations:** Fund V has a target size of \$3.0 billion, which is larger than its preceding funds in the series. Given the smaller target investment sizes inherent in the strategy and non-traditional property sectors, investment deployment could be slow. Fund IV is not quite fully invested despite having a 2020 vintage year, and this fund is \$2.6 billion with a 0.3x DPI in the third quartile compared to peers. Sculptor's investment process is thorough and consensus driven across the entire team, but this process may not be the most efficient with a larger fund size. Pacing for prior smaller funds also was fairly spread out with Fund III having a vintage year of 2014 at \$1.5 billion and Fund II having a vintage year of 2010 at \$840 million. Older Funds II and III with 2010 and 2014 vintage years are still not fully realized due to some investment stragglers, and these funds have had or will likely have to go beyond their extended terms. In spite of the extended terms, the DPI for these funds ranks in the first quartile. The Fund has a four year investment period from Final Close with a one-year extension option. Sculptor acknowledges that it will likely take up the entire investment period.

Management Fee

Sculptor will charge a management fee of 1.50%. The management fee will be on committed capital during the investment period and on invested capital following the investment period. Additional details on discounts for investment size and first close are as follows:

- For commitments that reach \$50 million, the management fee is discounted 25 bps to 1.25%.
- For commitments that reach \$100 million, the management fee is discounted 50 bps to 1.00%.



- For commitments that reach \$200 million, the management fee is discounted 75 bps to 0.75%.
- First Close (targeted for August 16, 2024) investors will receive a six-month fee holiday. Investors that commit within the first six months will receive a pro-rated share of the six-month fee holiday (e.g., an investor that closes 90 days after the first close will receive a 90-day fee holiday.)

Investor commitments subsequent to the Initial Close will be charged 8% catch-up interest for the time period after the Initial Close.

NEPC clients will receive a 12.5 bps discount on management fees if aggregate client commitments reach \$150 million, 25 bps discount if aggregate client commitments reach \$200 million, and 35 bps discount if aggregate client commitments reach \$300 million. This discount may be combined with individual client size-based discounts.

