Meeting Date
07/24/13
Agenda Item
#7

Memorandum

Date: July 12, 2013
To: CCCERA Board of Retirement
From: Timothy Price, Chief Investment Officer; Chih-chi Chu, Investment Analyst
Subject: Recommended Commitments to Distressed Real Estate Funds

Recommendation

In the staff memo to the CCCERA Board dated May 1, 2013, we laid out the potential budget for new commitments to real estate funds. In that memo, we laid out our recommendation that CCCERA could commit up to $60 million to value added funds and up to $175 to distressed real estate funds. We further recommended that these funds be targeted first to follow-on funds from existing managers, pending successful due diligence. CCCERA committed $60 million to value add real estate with the recent commitments to INVESCO III and Long Wharf IV. This memo details the case for additional commitments to distressed real estate.

Specifically, we recommend the Board make capital commitments of up to $80 million to Siguler Guff Distressed Real Estate Opportunities Fund II (DREOF II) and up to $70 million to Oaktree Real Estate Opportunities Fund VI (ROF VI), subject to successful due diligence and legal review. Both funds are follow-on funds, using the same teams and processes as when we committed to the prior funds, as outlined below.

Fund	Commitment Date	Commitment Size
Siguler Guff DREOF I	December, 2011	$75 million
Oaktree ROF V	December, 2011	$50 million

This memo evaluates Siguler Guff DREOF II and Oaktree ROF VI separately. We evaluate CCCERA's existing real estate investments with each firm, include a preview of the new funds' current and prospective investments, and finally, include a summary of each fund's terms.

Siguler Guff Distressed Real Estate Fund II

Overview

Siguler Guff is raising capital for Distressed Real Estate Opportunities Fund II, with a target fundraising range of $600 - $750 million. The $630 million Distressed Real Estate Opportunities Fund I (Fund I) has been fully committed and two-thirds drawn. Fund II is structured in the same way as Fund I, a fund-of-funds with approximately 40% of the fund allocated to co-investments (direct investments alongside the underlying fund managers).

Headquartered in New York City, Siguler Guff Advisers, LLC was founded in 1991 as the Private Equity group of PaineWebber. Siguler Guff became independent in 1995. The firm focuses on

niche investment opportunities such as distressed real estate and securities, BRIC (Brazil, Russia, India, and China,) and US Small and Mid-Cap private equity. Currently the four senior partners of Siguler Guff own 80% of the firm's equity and 100% of the firm's voting interests; BNY Mellon Asset Management has a 20% non-voting interest in the firm. The current assets under management of the firm are over $8 billion.

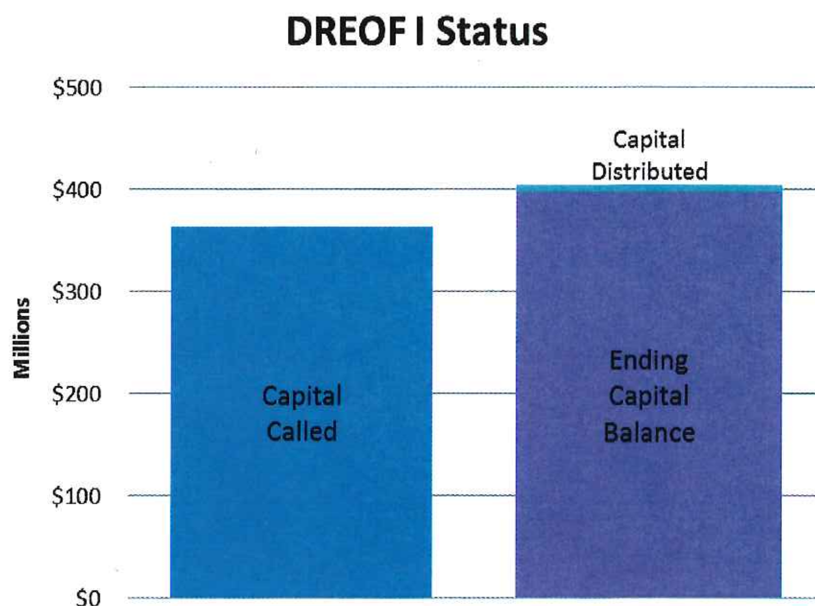
Review of Siguler Guff DREOF I

Siguler Guff's real estate investment program is relatively new compared to the firm's other offerings. However, the real estate program adheres to the firm's overall investment philosophy: to identify and exploit areas of market inefficiency and capital starvation. To fulfill this philosophy, Siguler Guff typically structures fund-of-funds investment vehicles through both fund investments and co-investments, with a conviction that its co-investments program will be beneficial to the overall investment performance.

CCCERA made its first capital call to DREOF I in early 2012. The following are highlights for DREOF I as of December 31, 2012:

- Fund Size — $630 million
- Number of Investments — 22
- Capital Called — $364 million
- Capital Distributed — $7 million
- Ending Capital Balance — $397 million
- Current Investment Multiple — 1.1 x
- CCCERA IRR % (gross/net) — 20.9/13.5

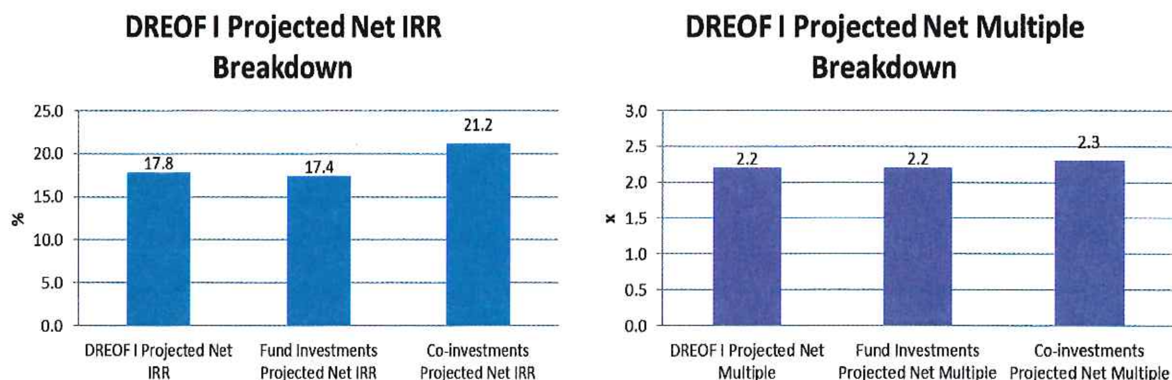
The chart below summaries the status of DREOF I as of December 31, 2012:



Although many investments in DREOF I are still too new to be meaningful from a return perspective, most investments in the fund are tracking well thus far. The current fund level net IRR is over 13% and the investment multiple is 1.1x. Out of the 22 investments already made in DREOF I, two are European funds, ten are North American funds, and ten are North American co-investments. European investments are over 10% of the total portfolio. The current investment level IRR ranges from -9.7% to 30.1%. The -9.7% investment remains in its J-curve due to up-front legal costs associated with this co-investment project.

DREOF I is projected to deliver a net IRR of 17.8% and an investment multiple of 2.2x at maturity, with the underlying fund investments projected to deliver net IRR of 17.4% and investment multiple of 2.2x, and the co-investments projected to deliver net IRR of 21.2% and investment multiple of 2.3x.

The charts below summarize the projected net IRR and net investment multiple of DREOF I, supported by the underlying funds and co-investments.



Siguler Guff DREOF II Investment Strategy

The fund's investment strategy is to commit capital to the portfolio in periods of distress. Siguler Guff will attempt to cast a wide net by geography, property type, investment vehicle and security type to capture assets at the best possible prices. Siguler Guff follows a strategy of partnering with local "sharp shooters" as the firm believes commercial real estate is still very much a local business. The fund's investment approach will remain flexible to pursue not only fund investments, but also joint ventures or co-investments.

DREOF II may potentially allocate a larger portion of the fund to Europe than DREOF I, as the firm believes that Europe is approximately two years behind United States in terms of distressed real estate opportunities coming to the market and will likely represent a relatively larger portion of the opportunity set during Fund II's investment period.

Approximately half of the underlying investment funds used in DREOF I will likely raise new funds that will be used in DREOF II. In addition to these follow-on funds, the investment

pipeline for DREOF II looks robust with fourteen new fund investment opportunities (over $400 million) and eight new co-investment opportunities (over $200 million) at this time. It is Siguler Guff's intention to have a first close when they have at least $150 million in commitments. They currently have 21 LP's with paperwork in hand for $27.6 million. They have another $75-80 million in hard circles for the first close (not including CCCERA).

Summary of Key Terms of DREOF II

Target Size:	$750 million (likely to be closed in the $600's range)
Siguler Guff Commitment:	At least $3 million
Target Initial Close:	August 30, 2013
Investment Period:	The Third Anniversary of Final Closing
Maturity:	The 12th Anniversary of the Initial Closing
Management Fee:	0.5% of Committed Capital if over $50 million (further fee break to be given for commitment at least $70 million in the Initial Close, that is, No Management Fee until $200 million is raised or for 3 months after the Initial Close, whichever event happens later)
Preferred Return:	8% compounded annually
General Partner Profits Interest:	5% (over return of LP's Capital plus Preferred Return to LP)
Investment Guidelines:	25% to any single Fund Investment; 25% to non-North America investments; 40% to Co-Investments (5% to single investment)

Oaktree Real Estate Opportunities Fund VI

Overview

Oaktree started raising Real Estate Opportunities Fund VI (ROF VI) in the summer of 2012, not long after closing the predecessor fund (Fund V) in December 2011 at $1.3 billion. ROF VI commenced operations on September 20, 2012. As of March 31, 2013 ROF VI has gathered committed capital of $653 million and is 70% drawn on that amount. Oaktree is in the final stages of closing ROF VI on or before September 20, 2013. Due to strong subscription demand, the final size of ROF VI could reach $2 billion, with a hard cap at $2.5 billion.

Oaktree was founded in 1995 by Howard Marks and four other partners. Headquartered in Los Angeles, the firm has approximately $79 billion under management. Since its founding, the firm has focused on less efficient markets and emphasized an opportunistic, value-oriented and risk-controlled approach to investments.

To generate liquidity for its employees, Oaktree went public in 2011, and currently has a market cap of $1.6 billion. Although it is a publicly traded company, the voting rights are retained almost entirely by its principals.

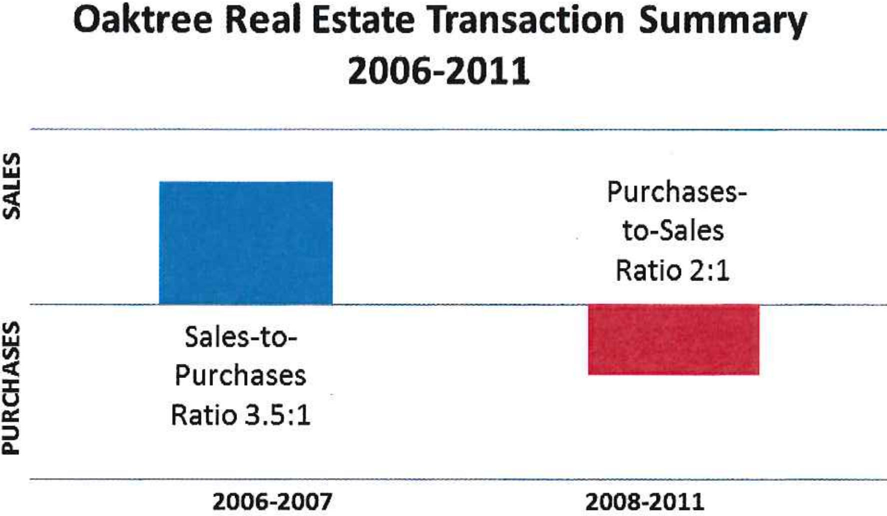
Oaktree Real Estate Track Record

Oaktree has been managing dedicated real estate investment programs since the firm's inception. It has managed nine funds prior to ROF VI. The track records of these funds, organized by the stage of the fund (Substantially Realized, Liquidating, Seasoning, or Investing) are summarized in the table below:

Fund Stage	Substantially Realized					Liquidating	Seasoning		Investing
Fund Name	SCF VI	ROF A	ROF B	ROF II	ROF III/IIIA	Legacy CMBS	ROF IV	Remington	ROF V
Start Date	August 1994	February 1996	March 1997	December 1998	October 2002	February 2010	June 2008	February 2010	February 2011
Capital (millions)	$505.5	$303.7	$285.5	$463.5	$707.3	$2,321.6	$450.4	$253.6	$1,283.0
Net IRR	17.4%	8.4%	7.1%	11.1%	11.9%	19.3%	12.8%	15.5%	11.0%
Net Multiple	2.1x	1.7x	1.6x	1.5x	1.7x	1.3x	1.5x	1.4x	1.2x

Oaktree attributes the consistent, strong track records largely to its counter-cyclical approach including selling assets during market peaks, expanding the capacity (both staff and capital) in advance of the opportunities and buying assets during the market trough.

As illustrated by the chart below, Oaktree real estate funds' ratio of assets sold to purchased was 3.5:1 during 2006-2007 real estate peak; the ratio of assets purchased to sold was 2:1 during 2008-2011 real estate crisis.



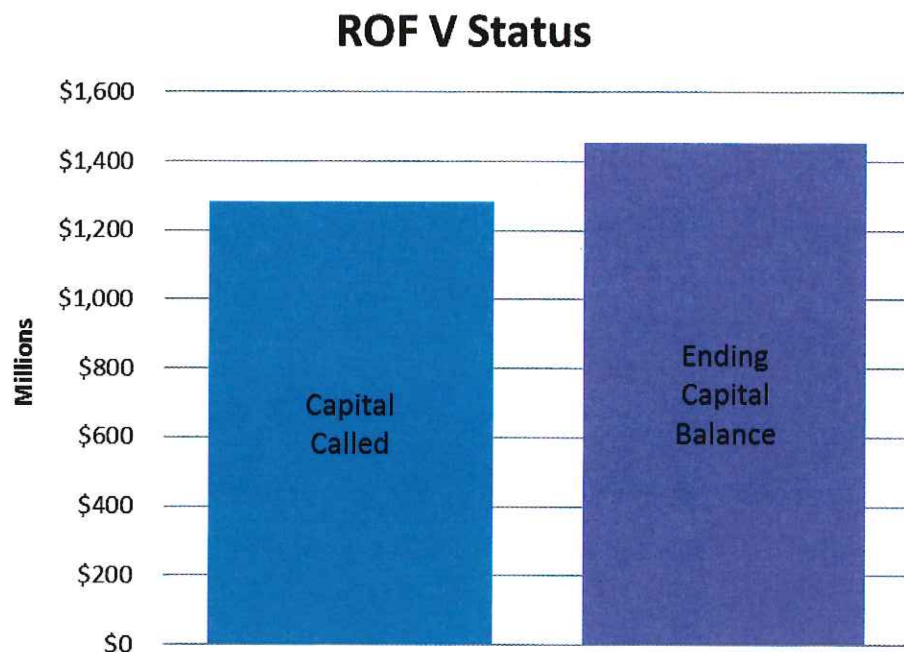
This record of buy-low/sell-high is somewhat unique and attributable to the value-sensitive investment process.

Review of Oaktree ROF V

CCCERA made its first contribution to ROF V at the end of 2011. The following are the highlights for ROF V as of March 31, 2013:

- Fund Size — $1.3 billion
- Number of Investments — 83
- Capital Called — $1,283 million
- Capital Distributed — $0 million
- Ending Capital Balance — $1,455 million
- Investment Multiple — 1.2 x
- CCCERA IRR % (gross/net) — 16.8/11.0

The chart below summaries the status of ROF V:



As of March 31, 2013, ROF V has realized five investments, mostly successfully, with gross investment multiple ranging from 1.0 to 2.3x. These exits together brought in net profits of over $15 million to the fund. The profits were recycled (re-invested). Most recently on May 13, 2013, ROF V sent out a $90 million distribution; CCCERA's share is $2.5 million.

The number of the unrealized holdings is 78, with the largest holding, Taylor Morrison, accounting for 7.8% of the fund. Taylor Morrison became public in on April 12, 2013. The IPO will bring ROF V a significant liquidity event once the lock-up period for the insiders expires 180 days after the IPO.

The current IRRs for the existing investments ranges from -29.7% (this investment has less than $500,000 of capital) to 53.1% (Taylor Morrison.) For the fund life return expectation, ROF V is currently projected to deliver a net IRR between 14 and 16% and an investment multiple of between 1.6 and 1.8x.

Preview of ROF VI

ROF VI has invested $430 million of committed capital in 22 investments. Consistent with ROF V, ROF VI will invest across six major categories: Commercial (Real Estate), Residential (Real Estate), FDIC/Bank Portfolios (deposition of real estate debts from the banks), Structured Finance (CMBS), Non-US, and Corporate Real Estate (such as Taylor Morrison, or REITs). Of the 22 investments already in ROF VI, Commercial Real Estate is by far the leading investment category with 50% of the invested capital, followed by Residential's 22% and FDIC/Bank Portfolios' 16%. The original underwriting investment multiple of the ten largest sample investments in ROF VI ranged from 1.4 to 2.5x.

Summary of Key Terms of ROF VI

Expected Fund Size:	$2 billion
GP Commitments:	2.5% (amount to be between $20 and $100 million) Current GP Commitment is 5.7% of already committed capital
Date of Final Close:	September 20, 2013
Commitment Period:	Three years from the date of final close
Management Fee:	1.5% of Committed Capital if below $150 million
Preferred Return:	8% compounded annual return to Limited Partners
Distributions:	100% to LP contribution plus preferred return; then 60%/40% GP/LP split up to 20% of all distributions above LP contributions (Catch-Up;) then 80%/20% LP/GP (Carried Interest)

Summary

Both DREOF I and ROF V have deployed investors' capital rather quickly. The investments, although too early to be realized, appear promising for both funds according to the most recent updates. DREOF II and ROF VI are expected to carry predecessor funds' deal momentum and investment pace. ROF VI has closed many attractive investments, and is tracking an enormous investment pipeline of more than $14 billion. DREOF II has a robust pipeline, including a couple of highly lucrative European opportunities.

Both DREOF II and ROF VI's total fee (simulated by Milliman and staff) including carry and underlying fund fee, work out to be approximately 4% for returns in the mid-teens; however Siguler Guff's fee schedule is more aligned with LP interest, as it draws more of its share of the fee from the investment success (versus regular management fee).

The combined recommended deployment of $150 million in Distressed Real Estate represented by DREOF II and ROF VI is consistent to the Real Estate Program Review approved by the board on May 8, 2013 (see attached).

Memorandum

Date: May 1, 2013

To: CCCERA Board of Retirement

From: Timothy Price, Chief Investment Officer; Chih-chi Chu, Investment Analyst

Subject: Real Estate Program Review

Overview

CCCERA last made real estate commitments to private funds in late 2011. Much of this previous round of commitments was put in place to better diversify our real estate exposure away from publicly traded REITs. Through these commitments, the REIT exposure has been reduced.

At this time, we are approaching our long-term target allocation of 3.5% exposure to REITs. However, our availability to commit to private Real Estate has grown due to the increase in total CCCERA value and meaningful distributions from the existing private real estate managers. With the anticipated wind down of four real estate funds as well as rapid deployment of the recently committed capital, CCCERA will need to make new commitments to maintain its target exposure to private real estate. This memo addresses CCCERA's availability to commit to private real estate and highlights the areas of the real estate market that appear most attractive at this time. If the Board approves of our recommended allocation ranges to various types of real estate, we will immediately begin vetting the strategies on offer from our current managers.

CCCERA Private Real Estate

Based on the March 31, 2013 market value of $5.95 billion, CCCERA has a 12.5% target allocation, or $744 million, to real estate. After subtracting the adjusted target of the REIT portfolios and the Willows Property, CCCERA has a dollar target of $528 million to private (closed-end) real estate funds. Compared to this $528 million target, actual CCCERA investment in closed end real estate on 3/31/2013 was $419 million. To address this imbalance, we propose that CCCERA make additional commitments to closed end real estate of $241 million.

As of March 31, 2013, CCCERA's closed-end real estate investments had a market value of approximately $419 million. Outstanding commitments to real estate which are to be drawn total $264 million. If the dollar target of $528 million is reduced by these amounts, CCCERA has an over-commitment of $155 million.

Given the nature of investing in closed-end real estate, at the beginning of a fund's life there is a lag period from when a commitment is made until when the actual dollars are invested. Later, when the fund approaches its termination and portfolio holdings mature, properties are sold, the portfolio eventually winds down, and capital is returned to investors. To recognize that investment in funds is often below the commitment level, CCCERA needs to over-commit relative to the desired target of $528 million to closed-end real estate in order to achieve the real estate target allocation of 12.5%.

We recommend that CCCERA commit to closed end real estate funds 175% of the $528 closed end target: $924 million. (These dollar amounts will change with the total market value of the fund, and as the total market value of CCCERA assets grows over time, the amount allocated to real estate also grows.)

Based on this analysis, the total amount currently available for CCCERA to commit to closed-end real estate funds is approximately $241 million. These figures are illustrated in the following table:

	Value (Millions)
CCCERA Total Fund	**$5,953**
as of 3/31/13	
Total Real Estate Target @ 12.5%	$744
less REIT Target @ 3.5%	$208
= Private Real Estate Funds Target @ 9%	$536
less Willows Property	$8
= Closed End Target	**$528**
Plus 75% over commitment	$396
= Adjusted Closed End Target	**$924**
Current Closed End Fund Commitments	
DLJ RECP II, III, IV	$123
Long Wharf FREG II, III	$65
INVESCO IREF I, II	$105
Oaktree V (new)	$53
Siguler Guff (new)	$46
Angelo Gordon VIII (new)	$27
=Total Current Investments	**$419**

Commitments Projected to Be Drawn

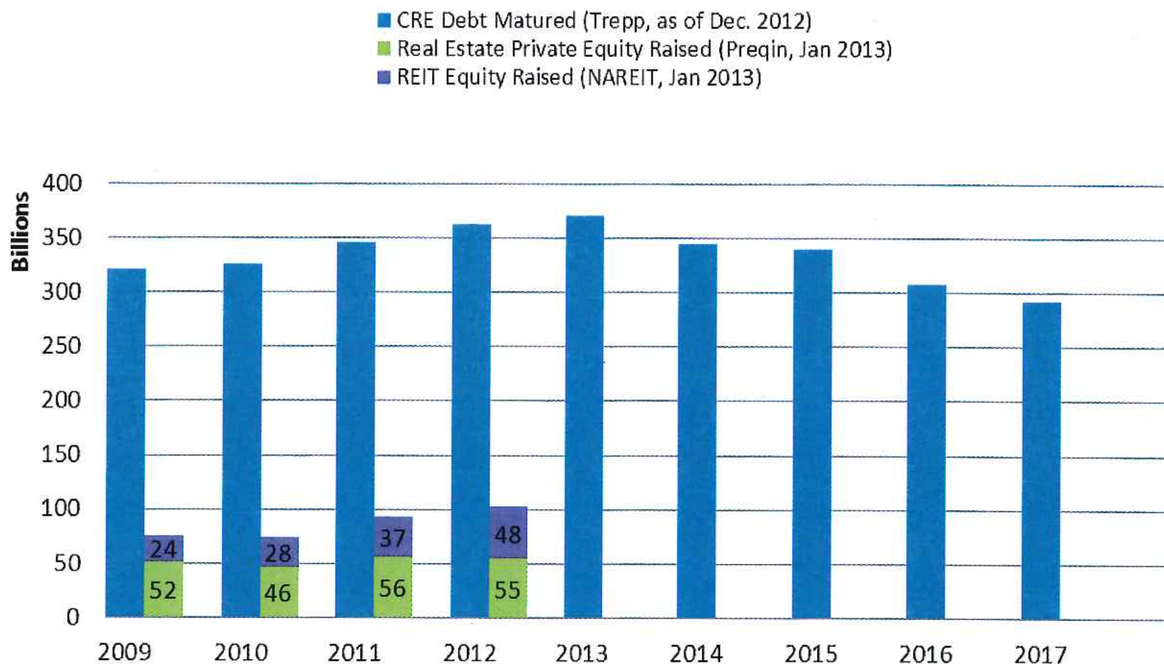
DLJ RECP II, III, IV, V	$113
Siguler Guff (new)	$28
Angelo Gordon VIII (new)	$48
LaSalle VI (new)	$75
= Total commitments to be drawn	**$264**

Adjusted Closed End Target	$924
less current Closed End Investments	$419
less existing closed end commitments	$264
Estimated Available to Commit	**$241**

Current Real Estate Market Trends
Since its peak in 2008, private real estate fund-raising has plummeted to pre-crisis levels. Much of the capital raised post 2008 has gone into the core assets (well financed, nearly fully leased class A properties in major markets), as investors become risk-averse after losing substantial amount of capital in non-core assets (which typically employ higher leverage) during the financial crisis. On the public side, the capital formation of REITs has increased since 2008; REITs are essentially core vehicles. As most of the equity raised, public and private, chase after the core assets, it leaves more opportunities than capital in non-core assets.

Distressed real estate markets present a significantly different story. The combined commercial real estate (CRE) debts that come due in the next several years are mounting to trillions of dollars (shown in the chart below). While there may be a continuance of "extend and pretend", we believe that more properties with problem loans will be unloaded onto the market, creating tremendous real estate opportunities through the distressed (debt) channel.

Commercial Real Estate Debt v. Equity

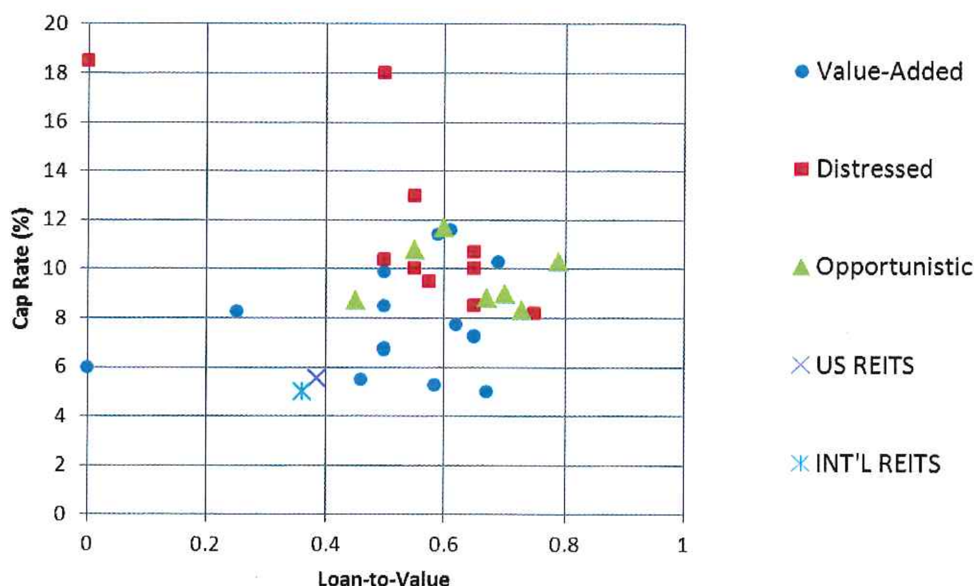


This trend shows up in CCCERA's experience from its recent round of real estate commitments. From December 2011 to April 2012, we committed $125 million, $155 million, and $75 million to Distressed, Opportunistic, and Value-Added strategies, respectively. While Opportunistic and Value-Added managers have been deploying capital at regular pace, the Distressed managers have either called or committed all their capital. Given the overall investment opportunities far exceeding the capital available to our Distressed real estate managers, their in-house distressed debt funds also participated substantially in these real estate-related opportunities.

Review of Current Pipeline Deals

To access the relative attractiveness of the different real estate strategies in the current environment, we surveyed two key statistics, cap rate and debt ratio, from all our real estate managers (including REITs) on their recently-closed transactions and potential deals in the pipeline. Cap rate represent the "value". In general, the higher the cap rate, the cheaper the property. Debt ratio, or loan-to-value (LTV,) represents the financial risk in the transaction. Below is the plot of all the transactions in the survey classified by strategy; the more upper-left corner it is in, the more attractive an opportunity.

Relative Attractiveness of Different Real Estate Strategies



As shown in the plot, CCCERA is compensated in terms of higher cap rates for the liquidity risk it takes from investing in private funds rather than REITS. While Value-Added and Opportunistic strategies appear to be finding similar cap rates, Distressed strategies appear to be capturing more low risk/high reward outliers. The relative attractiveness of Distressed strategy above also echoes the market opportunities review in the previous section. Being invested in core properties, public REITs offer a reasonable, though not terribly, attractive investment profile at this time. (If the Board wishes to further diversify the core real estate exposure, we may wish to pursue an open-end fund or the purchase of an individual stabilized building.)

Recommended Allocation

Based on CCCERA's current availability to commit, the market opportunities, the relative attractiveness of different strategies, and the pace of capital deployment from our existing managers, we recommend the following allocation of the next commitment for Board consideration:

Total Availability:	$240 million (to be drawn from REITs)
Value-added:	$60 million target, $0-60 million range
Opportunistic:	$25 million target, $0-25* million range
Distressed:	$155 target, $100-175 million range

*DLJ V, an opportunistic fund in which CCCERA committed $75 million in April, 2012, has yet to close and has not made any capital commitments .

The Distressed strategy is very appealing at this time, perhaps even more so than the last time we made our real estate commitment at the end of 2011. As more problematic CRE debts (with under-water properties) come due, the ability and willingness of lenders to extend the loans is becoming more limited, both due to regulation and fatigue. We believe Distressed real estate experts with extensive debt networks and debt/equity restructuring capabilities are well equipped to capture these investment opportunities.

We have a $75 million commitment to DLJ RECP V, which has yet to make its initial close. While we believe the Opportunistic space is quite attractive, the $75 million commitment is an appropriate allocation. If the Board wishes, we could modestly increase our commitment size, up to a maximum of $100 million total ($25 million incremental increase).

Among our Value-Added managers, both Invesco and Long Wharf are in the exit stage for current funds, while LaSalle will call 40% of the new capital in May, 2013. Without new commitments we will have very little exposure to the Value-Added strategy within the next several years.

Since our existing Distressed and Value-Added managers (except LaSalle) are in the market to raise the next fund, we can evaluate their current offerings with the Board authorization. Our Distressed managers have done very well in a short period of time; the Value-Added managers have managed through the severe real estate downturn reasonably well with anticipation of no or little loss of our capital, and some have the possibility of a meaningful upside.

Impact on CCCERA Combined Real Estate Portfolio

The following table displays the characteristics of closed end real estate funds available to institutional investors. It ranges from core (lower targeted return/lower risk) strategies to opportunistic (higher targeted return/higher risk) strategies. Core funds typically target returns in the mid-to-high single digit range, predominately from stable income streams such as apartments. Value-Added funds target IRRs from high single digit to mid-teens, while opportunity funds target returns in the high teens and above. Value-Added and Opportunistic funds will use higher leverage as well, typically above 60%, depending on the type of

investments and the debt availabilities in the market. The risk displayed here includes both financial risk and operating risk. For example, "re-tenant" or "development" projects certainly involve more operating risk than collecting rents and maintenance of core buildings. Note our distressed real estate managers, although targeting higher return, are either fund-of-funds or sit on multi-investment platforms (debt, equity, preferred shares, etc. ;) therefore their overall risk may be lower due to their inherently diverse investments.

Strategic Position of CCCERA Private Real Estate Managers

Strategy	CCCERA Manager	Investment Theme Example	Operating Risk	Financial Leverage	Target Return
Core	None	Office, Retail, Apartment with low vacancy in prime markets	Low	Low	Low
Value-Added	Invesco, Long Wharf, LaSalle	Tenant improvement	Medium	Medium	Medium
Opportunistic	DLJ, Angelo Gordon	Development project	High	High	High
Distressed	Oaktree, Siguler Guff	Recapitalization	Medium-High	Low-High	High

Currently, our strategy allocation, including both market values and commitments, for CCCERA's total private real estate portfolio is 45% Opportunistic, 30% Distressed, and 25% Value-added, as detailed in the table below:

CCCERA Existing Private Real Estate Strategy Allocation

Opportunistic	$311 million	45%
Distressed	$202 million	30%
Value-Added	$170 million	25%
TOTAL	$683 million	100%

Our recommendation, assuming with $25 million, $155 million, and $60 million allocated to Opportunistic, Distressed and Value-Added respectively, will result to the following allocation:

CCCERA New Private Real Estate Strategy Allocation

Opportunistic	$336 million	36%
Distressed	$357 million	39%
Value-Added	$230 million	25%
TOTAL	$923 million	100%

Based on the comparison of the two tables above, the new allocation will not drastically change from the old. However it will be able to capture the attractive market opportunities more directly.