December 15, 2006

MEMORANDUM TO: State Investment Council

FROM: O. Ike Michaels, Jr.
Deputy Director

SUBJECT: **Proposed Real Estate Investments in Prudential Property Investment Separate Account II and Capmark UK Realty Partners**

This due diligence memorandum is presented to the State Investment Council (the "Council") pursuant to N.J.A.C. 17:16-69.9 to report on proposed real estate investments of (a) $100 million in the Prudential Property Investment Separate Account II ("PRISA II") managed by Prudential Real Estate Investors ("PREI"); and (b) up to a limit of the lesser of 25% of the Fund or $50 million in Capmark UK Realty Partners, L.P. ("Capmark Fund") managed by UK Realty Investors GP, LLC ("UK Realty"). These investments represent one enhanced core fund (PRISA II) which fits the Strategic Portfolio and one international value-added fund (Capmark Fund) that fits the Tactical Portfolio.

Please note that these investments will be authorized pursuant to Articles 69 and 71 of the Council's regulations, which became effective on June 20, 2005. These investments will be considered real estate investments as defined under N.J.A.C. 17:16-71.2 (a) (1).

The Alternative Investments Procedures adopted by the Council on January 20, 2005 require any potential alternative investment opportunities to be identified and initially evaluated by the Head of Alternative Investments of the Division (Bill Clark in an acting capacity) and the applicable Asset Class Consultant (The Townsend Group for Real Estate, or "Townsend") in coordination with the DOI Investment Committee (Bill Clark and myself).

As a result of internal and external sourcing, the DOI Investment Committee identified the proposed investments, and Townsend and Division staff proceeded to undertake extensive due diligence on the proposed investments. We completed the same due diligence process as with all the other alternative investment opportunities presented to the Council.

Based on this due diligence, the Division has determined that the proposed investments meet the criteria for investments set forth in the Alternate Investment Procedures.

Prudential Investment Separate Account II (“PRISA II”), which will likely re-open to new investors in January 2007, is an open-end enhanced return fund with $5.2 billion in gross assets invested in 98 investments in the industrial, apartments, office, retail, hotel and land sectors using relatively low leverage (17% to 20%). Please note that we expect actual contributions to PRISA II to commence no earlier than June 2007.

PRISA II started investing in 1980 with the objective to exceed the NPI + 200 basis points. Since its inception, PRISA II has developed a steady group of regional/national joint venture partners who provide development and operating services, and has significantly outperformed the index and the peer group for the 1-year (20.8% gross vs. 17.6% for the NCREIF NPI), 3-year (20.8% vs. 16.4%%), 5-year (15.7% vs. 12.4%) and 10-year (11.9% vs. 9.3%) periods. As of June 30, 2006, the top ten assets represented 43% of the portfolio; while the top 15 assets represented 51% of the portfolio. Northern California and Washington, DC/Northern Virginia represented 5 of the top 10 assets.

PRISA is managed by Prudential Real Estate Investors (“PREI”), a business unit of Prudential Investment Management, Inc. (“PIM”) which is an indirect subsidiary of Prudential Financial, Inc. (“Prudential”). PREI has over $18.8 billion in real estate assets under management. PREI has been managing real estate for US institutional clients since 1970 and has a domestic staff of 280 individuals, including over 150 investment professionals with expertise in office, residential, industrial, multifamily and hotels in the domestic and international markets and a research team of 14 (10 in the US and 4 overseas). The firm is headquartered in Parsippany, New Jersey, and has offices in Atlanta, Chicago, San Francisco and Boston. Teams of Research Professionals are located in the U.S. and overseas and are fully integrated not only portfolio construction, but into the ongoing investment analysis as well.

The management fee is reasonable, and all the legal and economic terms associated with PRISA II are fair and consistent with market standards.

Capmark UK Realty Partners L.P. (the “Capmark Fund”) is a small unique pound sterling-denominated UK value-added fund available to select Capmark investors targeting a net annual IRR in excess of 14.0% by utilizing 70% leverage with an established lending platform for deal sourcing and local operating partner relationships for executing value-added strategies. While this is a small fund ($215M), it boasts 50% pre-specified assets in the retail (33%), office (51%), industrial (14%), and residential sectors (2%) acquired since December 2005 and contributed at cost.

The Fund sponsor, Capmark Investments, L.P. ("Capmark Investments"), an indirect subsidiary of Capmark Financial Group, Inc. ("Capmark"), which will co-invest 20% ($43M) of the Fund, is a registered investment advisor with an estimated $11.5 billion in real estate debt and equity assets under management for over 72 investors. The Real Estate Equity Group formed in 1996 is an established investment and funds management platform with over $1.9 billion of equity invested in the U.S. and the UK in 321 office, retail, industrial, and apartment properties with a total capitalization of $7.4 billion. As of June 30, 2006, realizations of 120 investments produced a net 28.5% IRR. Within the overall track record, the Sponsor's UK portion is comprised of $258 million of equity capital invested in 19 UK property ventures with a total capitalization of $934 million. Realizations of 8 investments in the UK produced a net 37.3% IRR.

Capmark seeks to grow their funds business in the UK as a natural extension of its successful U.S. equity business model, its resources, and investment style. In consideration of competing investment managers with longer track records of investing third-party capital in the UK, the Sponsor has assembled a substantial portfolio of attractive pre-specified assets to seed the Fund.

All the legal and economic terms associated with the Capmark Fund are fair and consistent with market standards.

Formal written due diligence reports for these proposed investments and all other information obtained by the Division on these investments were sent to each member of the DOI Investment Policy Committee of the Council on Friday, December 8, 2006, and a the Committee held a meeting on December 14, 2006 to review the due diligence reports prepared by Townsend and Division staff and other information for these proposed investments.

After review of the extensive due diligence and the approval of the commitment amounts referenced above, the Investment Policy Committee of the Council has decided to report on these proposed investments to the full Council pursuant to Step 4 of the Alternative Investments Procedures. Under these procedures, the Council may adopt or otherwise act on this report.

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 these investments. In addition, the proposed investments must comply with the Council's "pay to play" regulation (N.J.A.C. 17:16-4). While we are confident that we will work through these issues, the potential exists that a successful resolution may not be reached with one or more of these general partners.

We look forward to discussing these proposed real estate investments at the Council's December 21, 2006 meeting.

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Attachments