November 9, 2006

MEMORANDUM TO: State Investment Council

FROM: O. Ike Michaels, Jr.
Deputy Director

SUBJECT: **Proposed Real Estate Investments in Walton Street Real Estate Side Car V, Westbrook Real Estate Fund VII, Carlyle Realty Partners Fund V, Heitman Core Property Fund, and Morgan Stanley Prime Property Fund**

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 investment of (a) $25 million in the Walton Street Real Estate Side Car Fund V ("Side Car V") managed by Walton Street Capital L.L.C. ("Walton Street"); (b) $50 million in the Westbrook Real Estate Fund VII ("Westbrook VII") managed by Westbrook Partners ("Westbrook"); (c) $100 million in the Carlyle Realty Partners Fund V ("Fund V") managed by Carlyle Realty Partners ("Carlyle"); (d) $100 million in the Heitman Core Property Fund ("HCPF") managed by Heitman Capital Management, LLC ("HCM"); and (e) $150 million in the Morgan Stanley Prime Property Fund ("PRIME") managed by Morgan Stanley Real Estate ("MSRE").

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).

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.

The Walton Street Real Estate Side Car V ("Side Car V") managed by Walton Street Capital L.L.C. ("Walton Street") is a "side car" vehicle of Walton Street Real Estate Fund V ("Fund V") in which we have in place an approved commitment of $75 million. The Sidecar provides Fund V investors an opportunity to make additional commitments to Walton Street and Fund V in potential co-investment opportunities that meet the objectives of Fund V at a lower management fee. Consistent with prior funds, Walton Street is exploring several strategies for Side Car V and Fund V including: single asset and asset portfolios, targeted developments, international joint ventures, private equity platform investments with strong operating partners, complex ownership situations, and entity recapitalizations.

Walton Street has extensive experience with similar types of investments, and their track record with these investment strategies is strong. The management fee for Side Car V is quite good.

All the legal and economic terms associated with Side Car V are fair and consistent with market standards.

Westbrook Real Estate Fund VII ("Westbrook VII") is a global high return fund follow-on to the 2005 vintage Westbrook VI ("Fund VI"), which was the second fund sponsored by Westbrook Group to pursue opportunistic real estate investments resulting from: a) undervalued assets and portfolios, b) corporate and government divestitures, c) urgent recapitalizations, and d) ineffective ownerships. The Fund has a clear strategy of executing smaller off-market transactions in selected key markets that Westbrook believes are deep, liquid, vibrant and growing such as London, Paris, Tokyo, Washington DC, New York and San Francisco, and that may not be targets for some of the larger institutional sources of capital. In addition, Westbrook seeks to source transactions through its own systematic cataloging of targeted opportunities, local operating partners and third-party service providers who have an established presence in local markets, thus avoiding the more highly bid auction markets. The Westbrook funds are capitalized by a diverse group of 16 domestic institutional investors who are expected to invest Westbrook IV.

The management team - Westbrook Partners - consists of 37 professionals located in New York, San Francisco, London, Paris and Tokyo. Westbrook Partners and its key principals have a very successful track record of generating strong returns. Since 1994, Westbrook professionals have invested over $5.1 billion of equity in six previous funds. The gross IRR on all realized investments, representing $2.6 billion of equity invested, is 24.0%. The projected gross IRR over Funds I – VI is 24.7%, which represents $10.3 billion in projected proceeds and a 2.1 times return multiple.

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

__Carlyle Realty Partners Fund V ("Fund V")__ presents an opportunity to invest in U.S. "high return" opportunities with an established investment management team seeking to provide gross returns of approximately 20% to 30% by employing a bottom up opportunistic investing strategy in multiple property sectors including: retail development, office development and repositioning, for rent multifamily, hotels and senior living. The Fund is anticipated to raise $2.0 to $2.5 billion in net equity while employing a maximum of 65% leverage for an anticipated fund size in excess of $5.0 billion. The fund manager – Carlyle Realty Partners ("Carlyle Realty") - will co-invest up to 5% of the total fund value.

The Fund has a well-defined strategy of executing smaller off-market transactions in select key markets with strong growth potential and exit liquidity, such as New York City, Washington D.C., California and South Florida, and to date, has generated an aggregate gross realized IRR of 37% in 74 transactions including co-investment vehicles investing almost exclusively in the United States. For example, out of 143 investments across four funds totaling $1.2 billion in net asset value, approximately 70% of the investments were in the aforementioned markets. Most investments are sourced off market by Carlyle Realty staff and in certain instances, by venture partners of Carlyle Realty or through Carlyle's private equity platform. As a result of its proprietary deal sourcing network, Carlyle typically enters transactions from a control position and subsequently brings in the most desirable local operating partner at more favorable terms. Furthermore, Carlyle maintains relationships with a number of pre-eminent venture partners such as Sunrise Senior Living in the Senior Housing sector and Cypress Equities, an affiliate of The Staubach Company, on the retail front. In the case of Senior Housing, Carlyle was able to establish a captive operating partner (Carlyle Seniors Housing, L.P.) by hiring the two key acquisition individuals from Sunrise at the time the public company was transitioning from an owner/manager to solely a manager.

Carlyle Realty consists of 46 professionals located in Washington D.C., Los Angeles and Denver. This is the same team that was responsible for the successful investment of the prior funds and co-investments in the Carlyle Realty Partner series. Robert Stuckey and Chip Lippman are the two key individuals most crucial to the Fund's success. Mr. Stuckey is the Chairman of the Investment Committee and responsible for leading Carlyle's Realty Partners Series of funds. He is based in the D.C. office. Mr. Stuckey's past experience was in the REIT industry where he gained investing expertise in the office and industrial sectors while working with Carr America (Chief Investment Officer) and ProLogis (Senior Vice President focused on acquisitions and development). Mr. Lippman is also based in D.C. and is responsible for investment sourcing in D.C. and Chicago, as well as active in raising equity capital. Mr. Lippman's prior experience was in the REIT and investment banking industry where he worked for Carr America and in the real estate group of Friedman, Billings and Ramsey.

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

Heitman Core Property Fund ("HCPF") is a new open-end core fund which seeks to offer its lead investors an opportunity to invest capital in a timely manner with economic benefits not available in other existing open-end core funds, for example, low invested versus commitment fees; no transaction fees; and other available material discounts. HCPF's strategy is to invest and maintain a low-risk, broadly diversified portfolio of stabilized, income producing assets with the objective of executing a core strategy and delivering performance that is consistently favorable relative to the NCREIF Property Index ("NPI") and HCPF's competitive set over rolling five-year periods.

HCPF will be managed by Heitman Capital Management, LLC ("HCM") which has a long history of commingled and core separate account real estate investment management on behalf of pension funds, endowments, foundations, and other U.S. and international institutional clients investing in U.S. assets. With $15.2 billion under management (as of 6/30/06) and 175 investment professionals, HCM is 50% owned by 19 senior employees (average 21 years with the firm) who control all strategic, ownership and day-to-day operational decisions, and 50% owned by Old Mutual Plc ("Old Mutual") who provides HCM with new product investment capital, new channels of distribution, risk management, and internal auditing assistance. This employee-ownership structure creates a strong alignment of interest with clients.

HCM is headquartered in Chicago, and has offices in Northern and Southern California, Minneapolis, London, Luxembourg, Frankfurt, Warsaw, and Tokyo. Teams of fully-integrated research, portfolio construction, investment analysis, and financial reporting professionals are located in the U.S. and overseas.

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

Morgan Stanley Prime Property Fund ("PRIME"), in its 31st year of operation, is a preeminent open-end core, commingled U.S. real estate investment fund. With 199 assets totaling $5.9 billion in gross asset value ($3.5 billion in net asset value), PRIME invests in high quality, income producing commercial properties in primary markets, with a strong exposure today to high quality retail assets and Central Business District ("CBD") office properties. PRIME favors investing in major gateway markets, particularly coastal cities such as New York, Boston, Washington DC, Miami, San Francisco, Los Angeles and San Diego because these locations offer better liquidity, more diverse tenant bases and stronger resilience to market cycles.

PRIME continues to be a top quartile performer. For the one-year period ending March 31, 2006, total gross return for the period was 22.6% (3rd out of 10 core funds), 17.8% for the 3-year period (1st out of 8 core funds) and 12.2% on the 5-year measure (2nd out of 8 core funds). These results exceeded the NPI for each of these periods. PRIME will endeavor to maintain a high concentration of diversified investments in prime U.S. real estate offering stable, highly predictable cash flow returns. The focus will remain on high quality office buildings, top tier super regional malls, infill high demand multifamily product and assemblages of distribution warehouses in targeted primary markets. The investment strategy involves investing in the right segment within each property sector (e.g., currently, top-tier super-regional malls versus commodity retail assets).

Morgan Stanley's real estate franchise began in 1969 by providing real estate investment services to a variety of clients, including tax exempt investors, and in 1991 through its Morgan Stanley Real Estate Funds ("MSREF") program. In November of 2003, Morgan Stanley acquired a majority of the U.S. equity real estate assets of Lend Lease which were combined with existing real estate investing products of Morgan Stanley into a comprehensive, full-service real estate investing platform – Morgan Stanley Real Estate Investing. As a part of the Lend Lease transaction, Morgan Stanley acquired the advisory contract for PRIME Property Fund. In order to keep pace with evolving market trends and to make PRIME available to more types of investors, the PRIME management team has converted the Fund's ownership structure from an insurance company separate account to a limited liability company that operates as a private REIT. This structure provides the Fund with improved access to new capital and delivers greater liquidity, governance and transparency to investors. PRIME's investment strategy and core orientation has not changed and the transition of the lead portfolio manager role to Mark Albertson occurred smoothly.

All the legal and economic terms associated with this 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, November 3, 2006, and a the Committee held a meeting on November 8, 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 November 16, 2006 meeting.

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Attachments