Meeting Date
05/08/13
Agenda Item
#7

Memorandum

Date: May 8, 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 CCCERA's 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 fund 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 to closed end real estate funds, CCCERA will need to make new commitments to maintain its target exposure to private real estate. This memo addresses the funds available to commit to private real estate and highlights the types of real estate strategies that appear to be taking advantage of the most attractively valued which are poised for stronger relative returns at this time.

Please note that we have not attempted to address the relative attractiveness of individual property types (multi-family, office, industrial, etc.) or geographies (gateway U.S. cities vs. secondary markets, etc.) at this time. The majority of our current real estate managers are diversified across several sectors and geographies. Rather, we set out to determine what types of strategies were getting access to better valued properties and what kind of financial risk is embedded in their current pipeline of deals. If the Board approves the recommended allocation ranges to various types of real estate, we will immediately begin vetting the new funds available from our current managers and the property and geographical distributions will play a role in those analyses.

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 remaining 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 underweight and to take advantage of some of the relatively low property prices still available outside of the core real estate markets, we propose that CCCERA make additional commitments to closed end real estate of approximately $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 currently has an over-commitment of $155 million.

With the nature of investing in closed-end real estate, the beginning of a fund's life has a lag period from when a fund commitment is made until when the actual dollars are called by the investment manager. 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 the actual investment in real estate closed end 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**

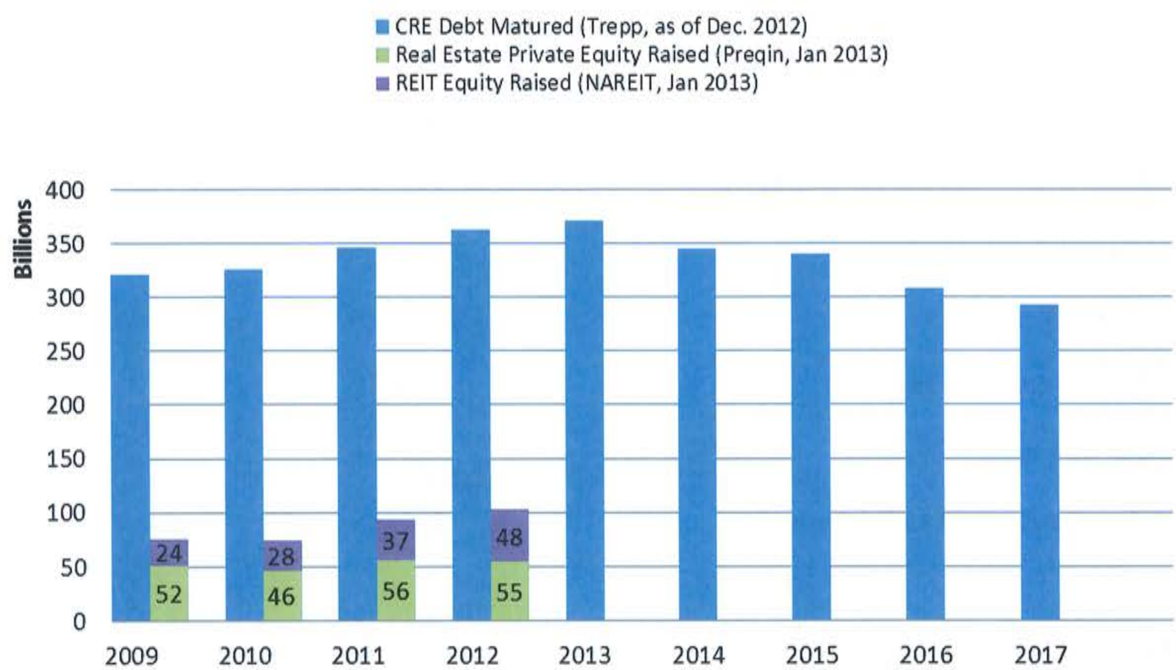
Adjusted Closed End Target	$924
less current Closed End Investments	$419
less existing closed end commitments	$264
Estimated Available to Commit	**$241**

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 available for investment in non-core assets. Depending upon the valuation method used, core real estate appears to be fully to slightly over-valued relative to its own history. Non-core properties continue to trade at lower valuations.

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



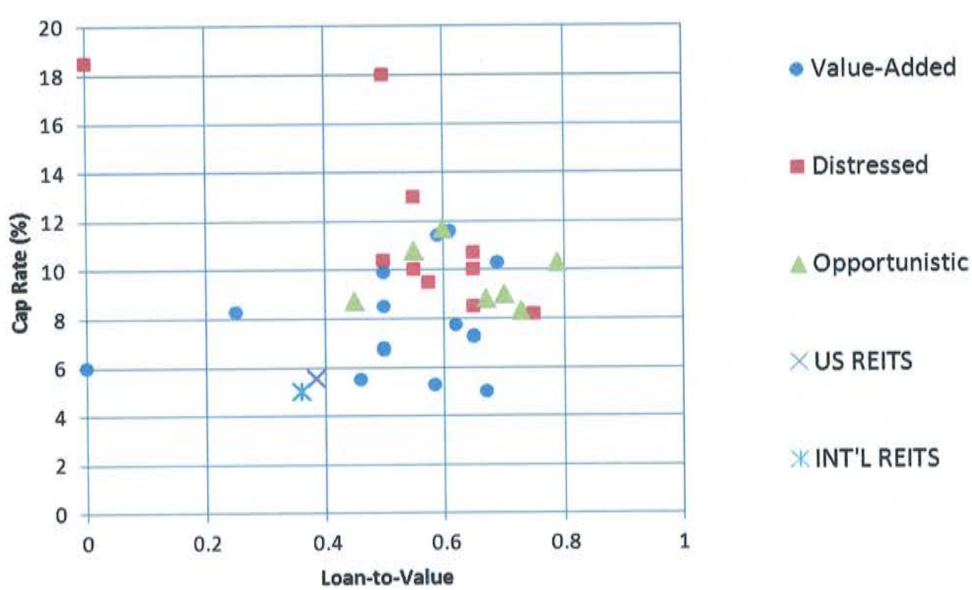
This trend mirrors CCCERA's experience from its recent round of real estate commitments. From December 2011 to April 2012 we committed $355 million to various real estate funds across the spectrum of Distressed, Opportunistic, and Value-Added strategies. While Opportunistic and Value-Added managers have been deploying capital at a regular pace, the Distressed managers have either called or committed all of their capital and have had greater opportunities than capital available to invest.

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, capitalization (cap) rates and debt ratios. We asked our real estate managers (including REITs) for these statistics for their recently-closed transactions and potential deals in the pipeline. Cap rates are a measure of the income generated by a property divided by the total value of the property and can be thought of as the yield produced. In general, a higher cap rates means that a property is generating more income per dollar invested which translates into stronger investment returns. The debt ratio, or loan-to-value (LTV,) represents the financial risk in the transaction since leverage amplifies the return on the investments. Less leveraged properties can better weather downturns but will offer more modest returns in rising markets.

The results of our survey are shown in the plot below. The northwest quadrant represents lower priced properties (higher capitalization rates) with less leverage (lower LTV ratio). These would be considered the more attractive investment opportunities.

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.

Recommended Allocation

Based on CCCERA's current funds available 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:	$241 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 simple fatigue of having to deal with some of these properties for more than five years now. 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 stages for current funds, while LaSalle will call 40% of committed capital in May, 2013. Without new commitments we will have 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 based on Board direction. 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 of up to 8% total returns based upon current forecasts from the managers.

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 fund investments.

Strategic Position of CCCERA Private Real Estate Managers

Strategy	**CCCERA Manager**	**Investment Theme Example**	**Operating Risk**	**Financial Leverage**	**Target Return**
Core	None, REITs used as a liquid proxy	Office, Retail, Apartment with stabilized income streams	Low	Low	Low
Value-Added	Invesco, Long Wharf, LaSalle	Tenant improvement, property lease up	Medium	Medium	Medium
Opportunistic	DLJ, Angelo Gordon	Development projects, repositioning	High	High	High
Distressed	Oaktree, Siguler Guff	Borrower recapitalization, significant retenanting	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
Invested Capital plus Uncalled Commitments

Opportunistic	$311 million	45%
Distressed	$202 million	30%
Value-Added	$170 million	25%
TOTAL	$683 million	100% this is the sum of invested (419) and uncalled (264)

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	$924 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.