MEETING DATE
SEP 11 2013
AGENDA ITEM
#7

Memorandum

Date: September 11, 2013
To: CCCERA Board of Retirement
From: Timothy Price, Chief Investment Officer; Chih-chi Chu, Investment Analyst
Subject: Paulson Real Estate Fund II

Recommendation

In the staff memo to the CCCERA Board dated May 1, 2013, we laid out a potential allocation of up to $175 million to distressed real estate funds. At the July 24, 2013 meeting the Board approved an $80 million commitment to Oaktree Real Estate Opportunities Fund V and a $70 million commitment to Siguler Guff Distressed Real Estate Opportunities Fund II (DREOF II), leaving $25 million still available to be committed in the distressed real estate space if compelling opportunities were identified.

Staff has since encountered a number of appealing investment opportunities in the distressed real estate space. The best among these is the Paulson Real Estate Fund II (PREF II). PREF II's predecessor fund, Paulson Real Estate Fund I (PREF I), is one of the investments for Siguler Guff Distressed Real Estate Opportunities Fund I (DREOF I) and is performing quite well to date, though no funds have yet been distributed. CCCERA committed $75 million to Siguler Guff DREOF I, and therefore has an indirect exposure to PREF I of roughly $4 million. DREOF II is likely to commit to a follow-on investment (~$40 million) to PREF II, resulting in an indirect exposure for CCCERA of roughly $4 million to PREF II.

We recommend the Board make a direct commitment of $25 million to PREF II, bringing up the total commitment to the Paulson distressed real estate group to a meaningful mid-$30 million level. Due to anticipated strong demand, the Paulson fund may cut back its allocations to certain investors. If, after Board approval, CCCERA's direct allocation is cut back to below $20 million, we recommend the Board withdraw the commitment intent due to the lack of scale for CCCERA.

Key Points

- PREF II buys finished and semi-finished residential lots, primarily by acquiring master-planned communities that were not developed due to the Great Recession.
- The fund then finishes or sells off lots as demand materializes from homebuilders.
- The fund focuses on markets with long-term growth of population, primarily in the sunbelt.
- The fund buys assets in the path of growth, or infill locations.
- The fund employs no leverage, and can therefore be patient when liquidating assets.
- The bulk of the value is created by buying low and being patient sellers.

Below is the summary of CCCERA's potential exposure to Paulson Real Estate Funds:

Fund	Channel	Commitment Size
Paulson Real Estate Fund I	DREOF I	~$4 million
Paulson Real Estate Fund II	DREOF II	~$4 million
Paulson Real Estate Fund II	CCCERA Direct	$-25 million

This memo provides an overview of PREF II, discusses the residential lot markets targeted by Paulson Real Estate team, reviews the track record of PREF I, previews PREF II's existing investments and portfolio outlook, and finally, includes a summary of the fund terms and other considerations.

Overview

Paulson Real Estate Fund II is sponsored by Paulson & Co., an investment manager founded by John Paulson in 1994. The company currently has approximately $19 billion under management, and offices in New York, London, and Hong Kong. Paulson & Co. is primarily known as a hedge fund manager, but PREF I & II are structured as traditional private partnerships. Both PREF I and PREF II are run by Michael Barr, Jonathan Shumaker, and John Paulson out of the New York office. In addition to its own management team, PREF II uses Raintree Investment Corporation (Raintree) to help with property management. Raintree is Paulson & Co's in-house residential land platform.

Paulson real estate funds are substantially invested in the targeted high growth markets. The GP will continue to source the acquisition opportunities in these markets through Paulson & Co and portfolio managers' extensive network. The exclusive in-house Raintree platform also provides the fund with regionally-based personnel directly sourcing investment opportunities in these target markets.

PREF II is expected to have a final close in the first week of November. The fund is targeting $400 million with a hard cap of $450 million. It has committed $170 million to eight investments which will be reviewed later in this memo. The fund has focused on residential land in Denver, Los Angeles, San Diego, Tampa, Phoenix, and Las Vegas. The fund is not betting on the housing recovery to continue (although a continuing recovery would be helpful), but rather buying residential lands cheaply in these long term high growth markets. The fund employs no leverage, and therefore will have no pressure to liquidate should the housing market turn sideways or downward.

Paulson's total holdings of residential lots is around 30,000, placing it in the top 10 homebuilder total owned lots list, behind DR Horton (117,000), Lennar (111,000), Pulte (100,000), KB Homes (35,000) and Toll Brothers (33,000).

Residential Lots Market

A common theme among U.S. homebuilders is that they overbuilt during the housing boom and underbuilt during the housing bust. During the boom, builders incurred debt to acquire residential lots to meet illusory demand for new housing starts. During the bust with demand for housing starts down sharply, they were often pressured by the debt burden to sell the residential lots acquired during the boom (often at a loss). This boom/bust cycle creates tremendous counter-cyclical selling/buying opportunities (of residential lots) for investors such as Paulson.

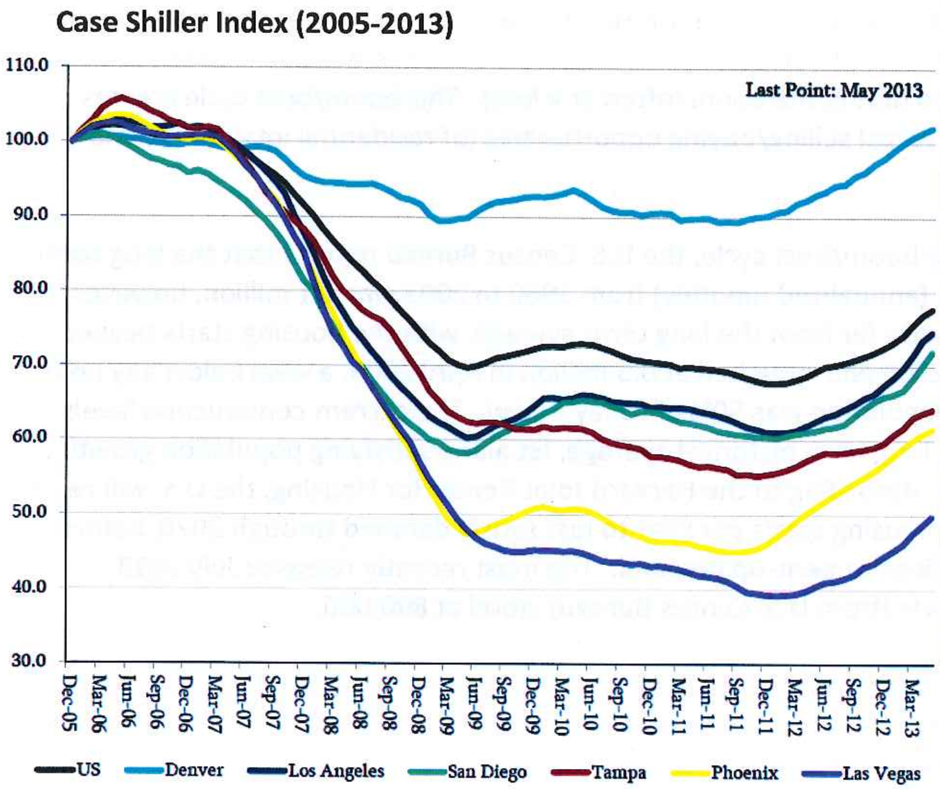
As an illustration of the boom/bust cycle, the U.S. Census Bureau reports that the long term average housing starts (annualized monthly) from 1960 to 2003 was 1.1 million, however the boom/bust figures deviate far from the long term average, with the housing starts peaked at 2.3 million in January 2006 and troughed at 0.5 million in April 2009, a level below any point since 1959 when the population was 50% of today's level. The current construction levels remain well below the long term historical average, let alone satisfying population growth and household formations. According to the Harvard Joint Center for Housing, the U.S. will require 1.3 to 1.6 million total housing starts per year to just satisfy demand through 2020, before accounting for demolitions or pent-up demand. The most recently released July 2013 annualized housing starts (from U.S. Census Bureau) stood at 896,000.

Meanwhile total shadow inventory including 60+ days delinquent, foreclosure, and REO has been steadily burned off coming out of the great recession, with 32% processed nationwide and 54% processed in Paulson's target markets.

The household growth figure (source: US Census Bureau, Moody's and Zelman) in Paulson's target markets also fares better than the general U.S. market, with a projected annual growth rate of 3.1% from 2011 to 2021 (compared to 1.1% in the general U.S. market.)

The real estate recovery has begun to show up in the tightening of the residential lot supply in Paulson's target markets. The historical demand for residential lots measured in years supply in Paulson's target markets is 1.5x; it has stretched to 4.1x with the current demand (Q1, 2013). This measure is calculated by the estimated annual demand over yearly supply of the lots. The higher the measure; the tighter the supply of lots.

Lastly presented on the residential market discussion is the Case Shiller Home Price Index with comparison of U.S. and Paulson's select markets, illustrated below:



Summary Statistics	Peak – 5/31/13	Trough- 5/31/13
Denver	1.0%	14.1%
U.S.	(24.0%)	14.7%
Los Angeles	(27.6%)	23.7%
San Diego	(28.6%)	23.5%
Tampa	(39.4%)	16.1%
Phoenix	(40.6%)	36.4%
Las Vegas	(51.4%)	27.0%

It is interesting to note that while most markets have shown significant price appreciation, all but one of Paulson's target markets is still far below the levels seen in late 2005.

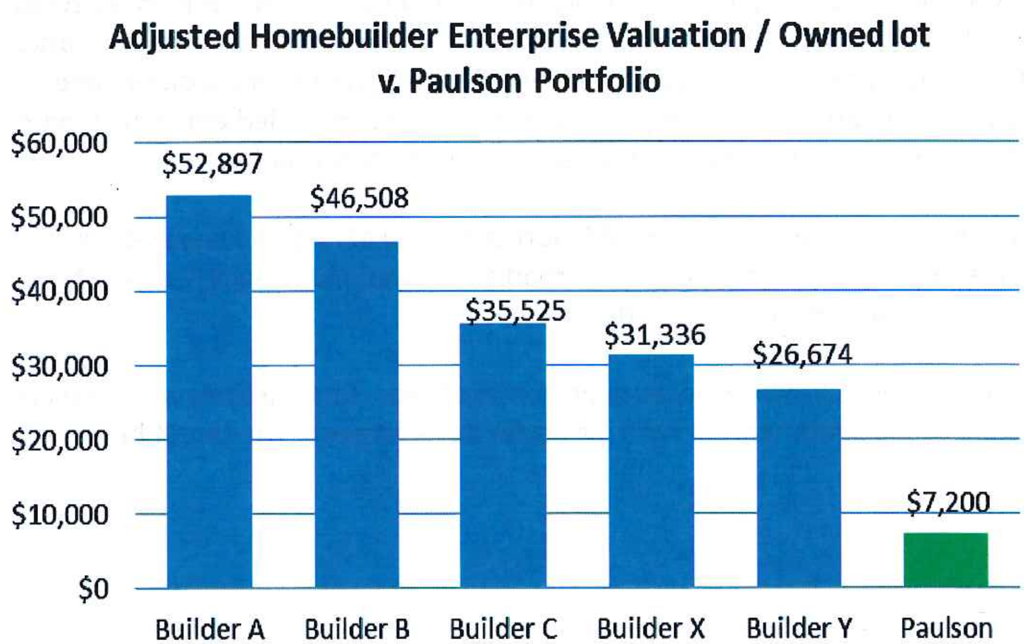
Review of Paulson Real Estate Fund I

PREF I held its final close in November 2010 on $317 mm and was fully committed to thirteen investments by May 2012. Siguler Guff DREOF I committed $35 million to PREF I. The following are highlights for PREF I as of March 31, 2013:

- Number of Investments 13
- Capital Called $33 million
- Capital Distributed $4 million
- Ending Capital Balance $39 million
- Current Investment Multiple 1.3 x
- Portfolio level IRR % 15.4%

A common theme across Fund I is an emphasis on severely distressed and bankrupt sellers. This focused allowed the fund to acquire quality assets at a low basis with little competition. The thirteen investments include eleven residential land investments and two hotel investments. All involved bankrupt or severely distressed sellers, thus the average cost per lot is well below peak valuations.

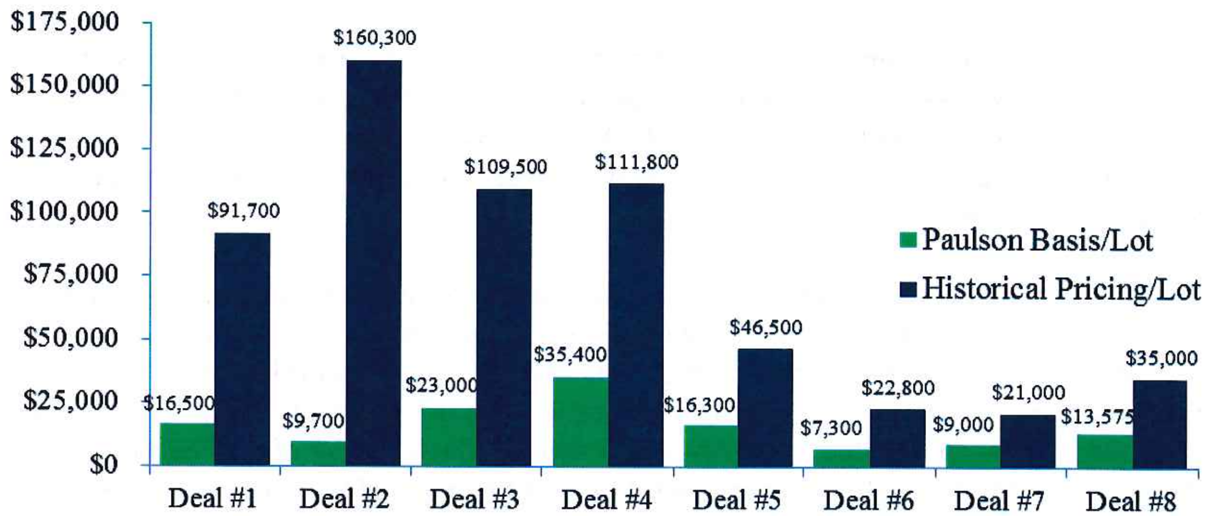
The chart below sourced from Zelman & Associates Research and Paulson & Co. shows the relative valuation per lot among PREF I and major U.S. homebuilders. The analysis was performed around October 2010 before PREF I's final close. It is not a perfect comparison considering many factors such as geographical location/size of the lots and the fluctuation of public builders' enterprise value. Nevertheless, it conveys the low basis of the Paulson portfolio. It also highlights the significant value in PREF I as many of the acquisitions were priced in 2009.



PREF II Preview

Fund II will follow the same residential land investment strategy as Fund I, namely: (i) target investment opportunities within the high growth, high distress sun-belt markets (Southeast, Southwest, and West Coast); (ii) create a low holding cost in high-quality assets; and (iii) structure its investments on an unlevered basis.

As mentioned briefly in the earlier Overview section, Fund II is targeting a fund size of $400 million. It has closed on eight investments since May 2012 with a total commitment of $170 million, representing 9,117 lots. Again, the cost basis for these lots is low, as shown below.



The historical prices are derived from several sources. Deals #1 and #3 are peak value estimates from 2006; Deal #2's estimate is based on an allocation of the debt amount in 2008; Deal #4 is based on the estimated 2002 sales price; Deal #5 is based on a contracted sales price in 2005 on which a non-refundable deposit was paid, but that sale was never consummated; Deal #6 is based on the estimated 2004 sales price; Deal #7 is based on scaled enterprise value on August 25, 2013; Deal #8 is based on the estimated 2004 sales price/per lot.

To further illustrate the value in the existing PREF II portfolio, Deal #1, 2 and 3 were acquired below the cost of the existing improvement such as road and sewer, etc. Deal #7 is an out-of-bankruptcy IPO that will bring a near term upside exit.

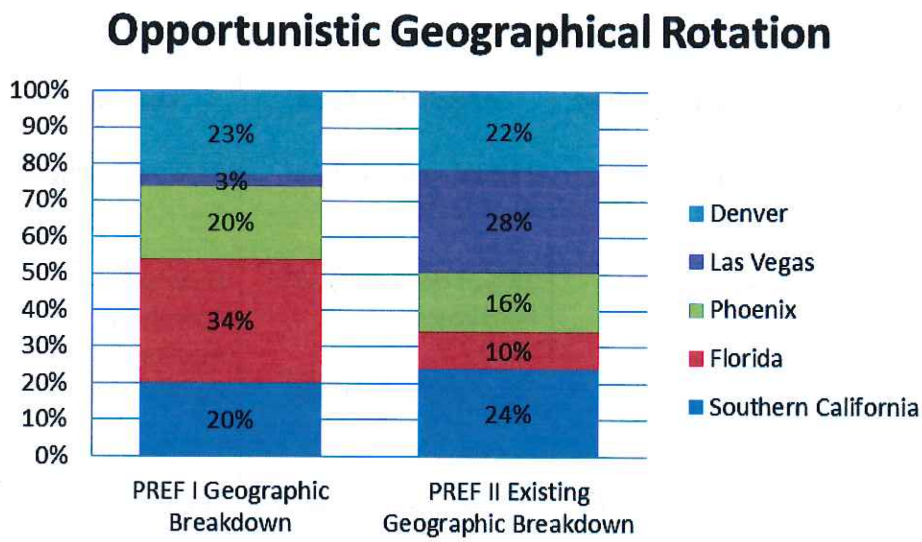
The fund will pursue sales of its holdings on an opportunistic basis. This will likely mean selling lots in phases in order to build momentum for a particular development. The target buyer will be homebuilders.

Below is the table summary of these deals' characteristics.

Type	Market	Date Acquired	Acquisition Basis	Deal Source
194 cheap-to-finish lots	Phoenix	September 2012	21% of peak / 69% of hard costs	Bank Acquisition
670 finished and partial lots	Phoenix	May 2012	18% of peak / 47% of hard costs	Note Sale, Foreclosure Auction
3,338 partially improved lots	Las Vegas	July 2012	6% of allocated debt	Post-bankruptcy
492 entitled, raw lots	Los Angeles	February 2013	31% of 2002 sale price	Fee simple acquisition
1,655 paper lots	Perris, CA (Northern San Diego and East LA play)	May 2013	32% of 2004 sale price	Asset Sale
1,768 paper lots	Erie, CO (Boulder and Denver play)	August, 2013	39% of peak	Asset Sale
2.2 million SF mixed use, 1,000 residential units	Miami	February 2013	35% of 2004 hard contract	Mortgage Acquisition
10.6% ownership (10,042 controlled lots and homes)	Homebuilder in bankruptcy	October 2012	45% of August 30, 2013 security closing price	Convertible Preferred / Common Stock

The existing portfolio of $170 million represents over 40% of the fund II target size ($400 million), making PREF II one of the more visible private deals CCCERA has recently considered. The pipeline also looks robust with 4 deals worth of $70 million likely to be closed at Paulson team's discretion in the next two quarters and another 7 deals worth of $200 million in negotiations.

The GP, although committed to the target markets, remains tactical among these high growth markets. The comparison chart below between Fund I and II's geographical exposure shows the GP's evolution of target markets as the real estate market recovers in an uneven fashion.



Summary of Key Terms of PREF II

Target Size:	$400 million (hard cap $450 million)
GP Commitment:	$125 million
Target Final Close:	November 8, 2013
Target IRR:	20% net to LPs
Investment Period:	Three years from the Final Closing
Maturity:	8 years from the final closing plus two one-year extension options (who exercises these options?)
Management Fee:	1.5% of committed capital during the investment period; 1.5% of unreturned invested equity after Investment Period No Acquisition or Disposition Fee
Preferred Return:	9%
Carried Interest:	20%
Catch-up	60% to GP / 40% to LP

Risks

The most prominent risks associated with this strategy include the following:

1. Headline Risk
   Paulson tends to attract some negative attention with regards to compensation of the portfolio managers and their counter cyclical positions relative to large macroeconomic developments. However, this early bet on residential lots for the housing recovery seems to be performing well to date.

2. Business Risk
   Paulson & Co. is primarily a hedge fund organization. We have not vetted the strength of the hedge fund business and there is always a risk that one or more of these hedge funds could falter, and potentially damage the financial health of the overall company. Mr. Paulson is personally the largest investor in Funds I and II. The real estate funds are structured as traditional private partnerships, unlike other the firms hedge fund offerings which tend to be much more liquid. In the event that the hedge fund business falters, the real estate strategy should be able to continue their investments. If need be, the real estate group could become independent or be sold relatively easily as they are not deeply embedded with the firm's other strategies.

3. Real Estate Recovery
   If the real estate market falters again, at the very least our hold time would be extended considerably. The lack of leverage in the fund mitigates the concern of a longer hold time.

4. Poor Execution
   PREF II focuses on specific markets that portfolio manager has identified as having long-term growth. If the targeted cities do not experience significant new housing starts within the life of Fund II, the results will be lackluster. However, both the long term population growth trend and the limited existing inventory seem to favor Paulson's target markets.

Summary and Other Consideration

While the recent surge of the U.S. housing sales figure brings optimism to the general economy and will continue to help with the exits of PREF I & II, our major consideration for this investment is on the buy side of the story – that is to acquire residential lots at a very low basis with no leverage in the targeted high growth markets hit particularly hard during the great recession.

The finished lots and overhang inventories have steadily declined nationwide over the past few years as homebuilders and buyers slowly but surely absorb the excess lot inventory from the market peak. Meanwhile very few land owners have been assembling, entitling and developing lots as a result of the downturn and lack of project financing. With the long term expected population and household formation growth in Paulson's target markets, the residential land in these markets will eventually swing from an excess to a shortage of entitled, viable home sites. Paulson intends to sell in time of constrained supply.

This commitment, if approved, will likely be CCCERA's last allocation to distressed real estate for this business cycle. The combined direct and indirect Paulson exposure (~$35 million) will be less than 4% of CCCERA's total private real estate holdings (>$900 million), yet meaningful enough (10% in the distressed real estate) to make a positive impact on distressed sector's risk-adjusted return.