

January 12, 2007

MEMORANDUM TO: State Investment Council

FROM: O. Ike Michaels, Jr.
Deputy Director

SUBJECT: **Update on 2006-07 Investment Plan and Proposed Real Estate Investment in Blackstone Real Estate Partners VI**

This due diligence memorandum is presented to the State Investment Council (the "Council") pursuant to N.J.A.C. 17:16-69.9 to provide: a) an update of the Real Estate Plan for fiscal 2006-07 and where we expect to be at the end of the fiscal year; and b) report a proposed real estate investment of \$100 million investment in the Blackstone Real Estate Partners VI, L.P. ("BREP VI") which fits with the Tactical Portfolio.

Please note that the investment 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. 17:16-69.9(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 investment, and Townsend and Division staff proceeded to undertake extensive due diligence on the proposed investment. 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 investment meet the criteria for investments set forth in the Alternate Investment Procedures.

A. Investment Plan Update

By the end of fiscal year 2007, we expect to have made commitments of about \$1.8 billion compared to \$1.1 billion as contemplated in the Plan in order to continue to take advantage of current opportunities in the real estate market. As of December 31, 2006, we have committed \$1.2 billion in twelve funds under the 2006-07 Plan of which 53% fits in the

Strategic Portfolio and 47% in the Tactical Portfolio (35% in the Global and International sectors). Since inception, we have committed \$1.9 billion in twenty one funds representing 45% in the Strategic Portfolio and 55% in the Tactical Portfolio (20% in the Global and International sectors).

On the domestic front, the public equity markets in particular continue to perform well relative to the past three years, and the capital markets continue to recognize real estate as a strong asset class. Investment demand for real estate, therefore, remains strong, maintaining upward pressure on prices and downward pressure on capitalization rates. As a result, we remain active buyers of enhanced core assets, and continue to pursue relationships with value-add and opportunistic partners to take advantage of dislocations in pricing in various areas from development and redevelopment of traditional asset types to non-core strategies.

On the international front, Japan, the world's second-largest economy, is showing modest signs of recovery after more than a decade of stagnation. Despite the rebound, distressed real estate opportunities remain relatively abundant in Japan. Europe is largely stable, with pockets of growth, and other markets for real estate investment (Latin America, India, Eastern Europe, the Far East (other than Japan), and China) all appear to be attracting institutional investment. Opportunities therefore remain abundant in global opportunistic strategies in high growth or recovering economies, and we continue to evaluate additional commitments to exiting or new partners in these areas as well as some new commitments in markets not currently covered by our existing investment strategies.

B. Proposed Investment in Blackstone

Blackstone Real Estate Partners VI ("*BREP VI*") is targeting \$8 billion of commitments and is the successor fund to *BREP V*, which in less than 12 months has invested approximately \$5.4 billion or 98% of the original committed capital with exceptional performance to date. *BREP VI* is expected to continue to seek to focus on acquiring institutional quality assets that have certain flaws, implement a strategy to correct those flaws and subsequently seek to dispose of the assets into the deep capital markets seeking "core" investments, and like its predecessor funds, continue to be flexible and nimble and adjust its acquisition strategy as the markets adjust over time. Although we do not anticipate *BREP VI* will invest capital at the same pace of *BREP V*, it is also likely to focus on public to private transactions; large transactions; recovering office markets; hotel repositionings; and international investments.

In November 2006, the Blackstone Real Estate Group announced the acquisition of Equity Office Properties ("EOP") for \$36 billion requiring \$6.2 billion of equity before reserves. The \$6.2 billion equity commitment will be made by *BREP V*, the investment banks providing the financing for the transaction, and potentially by *BREP VI*. The EOP transaction is expected to close on February 8, 2007. However, the exact total equity required to complete EOP's acquisition is not known at this time as a result of potential EOP asset sales and EOP operating partnership unit holders who may elect to convert to preferred equity (rather than take cash) in conjunction with the transaction.

The BREP VI management team remains the same, including the seven Senior Managing Directors and Managing Directors who have worked together since BREP I. John Schreiber, Co-founder of Blackstone Real Estate Advisors, continues to co-chair the Real Estate Investment Committee with Steve Schwarzman. The entire group, along with long time Investment Committee Members, Steve Schwarzman, Tony James and Ken Whitney, continue to oversee the investment process in the same manner that has led to our successful 15 year track record. Overall, the team has grown from 62 full time real estate professionals one year ago, to 74 full time people today. This team is augmented by the scores of professionals involved in running the portfolio companies we have purchased over the last several years.

The legal and economic terms associated with BREP VI are fair and consistent with market standards.

Townsend is completing its formal written due diligence report for the proposed investment and in all likelihood will resemble its prior report for BREP V as the strategy, fund terms, and management team remains the same. However, various other information obtained by the Division on this investment were sent to each member of the DOI Investment Policy Committee of the Council on Friday, January 5, 2007, and the Committee held a meeting on January 11, 2007 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 this proposed investment 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 the investment. In addition, the proposed investment 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 the updated 2006-07 Plan and proposed real estate investment at the Council's January 18, 2007 meeting.