



State of New Jersey

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September 16, 2014

MEMORANDUM TO: The State Investment Council

FROM: Christopher McDonough
Director

SUBJECT: **Proposed Investment in True North Real Estate Fund III, L.P.**

The New Jersey Division of Investment (“Division”) is proposing an investment of up to \$100 million in True North Real Estate Fund III, L.P (the “Fund”). This memorandum is presented to the State Investment Council (the “Council”) pursuant to N.J.A.C. 17:16-69.9.

The Division is recommending this investment based on the following factors:

Compelling Opportunity Set: Post-crisis, access to debt for commercial real estate plummeted to levels not seen since the recession of the early 1990s. Aggressive property-level business plans failed to materialize, which dramatically increased the amount of nonperforming and sub-performing loans across the US. Since then, senior mortgage capital has largely returned for fully-leased, cash flowing assets in major markets, but transitional assets in suburban and secondary markets have had trouble finding the same level of interest, creating a massive funding gap.

Large Addressable Market: Since the start of the financial crisis, Real Capital Analytics estimates that over \$467 billion of commercial real estate assets have become troubled. Since then, only \$261 billion has been resolved, leaving ample supply of existing distress while new supply will come from the estimated \$1.5 trillion of commercial real estate debt facing maturity before 2017. Owners do not want to invest further at their current basis and lenders do not want to hold troubled loans.

Proven Track Record with significant downside protection: True North (the “Firm”) has been successful by maintaining discipline in executing a high-yield debt focused strategy, focusing on conservative structures and cash flowing assets, avoiding speculative bubble assets, and avoiding strategies that require high levels of leverage and financial engineering to generate returns. Fund I, a 2006 vintage, produced top quartile returns during a challenging time for real estate investment. While Fund II has exhibited strong absolute performance to date, True North’s conservative leverage utilization (Fund II is 32% levered) relative to its peers has contributed to second quartile performance by multiple of invested capital and fourth by current IRR standards. However, Fund II has already realized 56% of the equity it has invested; in the three deals it has fully sold the aggregate Net IRR is 59% with a 1.5x net multiple; and is still tracking to a 16.2% Net IRR and a 1.6x net multiple of invested capital. The Firm’s disciplined approach to risk mitigation has also resulted in one investment out of 54 that is projected to return less than a 1.0x multiple of invested capital (“MOIC”).

Extensive experience across multiple sectors and cycles: The team has extensive experience with debt restructurings and property level operations, allowing them to pursue a broad range of transactions including the

Fund's three target transaction types: distressed debt, opportunistic equity and rescue capital. In addition, their long tenure in the industry gives them a broad sourcing network.

Complementary exposure to existing Real Estate Debt Portfolio: The Division's real estate debt portfolio currently does not have any exposure to opportunistic funds focused in the US. Currently, CT High Grade is focused on core. Guggenheim, which is winding down, is focused on collectivized mortgaged back securities and trophy properties. Lone Star invests in large portfolios, and the M&G funds are focused on European Mezzanine opportunities. True North also targets smaller properties outside of major markets, which have not garnered as much attention from institutional capital following the financial crisis. An investment with True North presents a compelling opportunity to fully round out the Division's real estate debt portfolio, and provide complementary exposure in small and mid-size real estate assets at an attractive basis.

Attractive Terms: Given the meaningful size of the Division's commitment, staff and RVK were able to negotiate a 1% management fee with a two-month initial fee holiday, which effectively brings the overall management fee down to 0.98%. The fund also has a 9% preferred return and a more LP-friendly GP catch-up mechanism.

A report of the Investment Policy Committee ("IPC") summarizing the details of the proposed investment is attached.

Division Staff and its real estate consultant, R.V. Kuhns and Associates, Inc., undertook extensive due diligence on the proposed investment in accordance with the Division's Alternative Investment Due Diligence Procedures.

The Fund utilized Atlantic-Pacific Capital, Inc. (the "placement agent") as third-party solicitor in connection with the potential investment. Staff has determined that the placement agent and its representatives met the registration, licensing and experience requirements set forth in the Division's Placement Agent Policy (the "Policy"). Pursuant to the Policy, the Fund has disclosed the contract between the Fund and the placement agent, specifying the scope of services to be performed by the placement agent and the fee arrangement between the placement agent, the general partner and any other third party.

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. We have obtained a preliminary Disclosure Report of Political Contributions in accordance with the Council's regulation governing political contributions (N.J.A.C. 17:16-4) and no political contributions have been disclosed. We will obtain an updated Disclosure Report at the time of closing.

Please note that the investment is authorized pursuant to Articles 69 and 71 of the Council's regulations. The True North Real Estate Fund III, L.P. will be considered a non-core real estate investment, as defined under N.J.A.C. 17:16-71.1.

A formal written due diligence report for the proposed investment was sent to each member of the IPC and a meeting of the Committee was held on September 9, 2014. In addition to the formal written due diligence report, all other information obtained by the Division on the investment was made available to the IPC.

We look forward to discussing the proposed investment at the Council's September 16, 2014 meeting.

Attachments

Fund Name: True North Real Estate Fund III, L.P

September 16, 2014

Contact Info: Brent Morris, 44 South Broadway, 10th Floor, White Plains, NY 10601

Fund Details:

Total Firm Assets :	\$856 million	Key Investment Professionals: Richard Gunthel, Founding Principal. Previously, Mr. Gunthel was a Managing Director and Head of the Real Estate function of the Alternative Investment Division of Deutsche Asset management. Paul Turovsky, Founding Principal. Previously Mr. Turovsky was a Managing Director of Deutsche Bank Securities and Fund Manager for Deutsche Bank Real Estate's High Yield Investment Funds Desmond McGowan, Principal and CFO. Mr. McGowan is the Chief Financial Officer for True North Management Group, where he is responsible for financial reporting, investor reporting and treasury management along with information technology and human resources. Prior to joining True North in September 2008, Mr. McGowan was the CFO of the Community Preservation Corporation and its subsidiary, CPC Resources.
Strategy:	Non-core Real Estate Debt	
Year Founded:	2004	
Headquarters:	White Plains, NY	
GP Commitment:	1%	

Investment Summary

True North Real Estate Fund III, L.P. (the "Fund") will focus on investments in high yield commercial real estate debt and equity in the United States. Within their distressed debt investments, the Fund will seek to purchase deeply discounted non-performing loans on assets burdened by legacy capital structure issues or undercapitalized sponsorship. In addition, they also seek to acquire sub-performing loans at discounts from banks and insurance companies.

Existing and Prior Funds

<u>Funds</u>	<u>Strategy</u>	<u>Vintage</u>	<u>Returns as of 6/30/2014</u>
Pre-Fund	Non-core Real Estate Debt	N/A	17% Proj. Net IRR; 1.7 x Proj. Net Multiple
Fund I	Non-core Real Estate Debt	2006	9% Proj. Net IRR; 1.6 x Proj. Net Multiple
Fund II	Non-core Real Estate Debt	2010	16% Proj. Net IRR; 1.6 x Proj. Net Multiple

IRR = Internal Rate of Return

Vehicle Information:

Inception:	2014	Auditor:	KPMG LLP
Fund Size (\$mil.):	\$650M	Legal Counsel:	K&L Gates
Management Fee:	1.0%, discounted from the standard 1.5%, which is charged on capital commitments through the investment period and on contributed capital thereafter. Staff and RVK negotiated a two-month initial fee holiday, which effectively brings the overall management fee down to 0.98%		
Carry:	20% [GP receives 20% of profits over 9% until they reach 12%, then a 70% GP catch-up over a 12% hurdle to a 20% promote (vs. 50/50 GP catch-up over a 9% preferred for other investors)]		
Hurdle Rate:	9%		
Additional Expenses:	100% fee offset		

NJ AIP Program

Recommended Allocation (\$mil.):	up to \$100,000,000	LP Advisory Board Membership:	TBD
% of Fund:	15.38%	Consultant Recommendation:	Yes
		Placement Agent:	Yes
		Compliance w/ Division Placement Agent Policy:	Yes
		Compliance w/ SIC Political Contribution Reg:	Yes

*This review memorandum was prepared in accordance with the State Investment Council rules governing the Alternatives Investment Program and the policies and procedures related thereto.