

March 14, 2008

MEMORANDUM TO: State Investment Council

FROM: William G. Clark
Director

SUBJECT: **Proposed Real Estate Investment in
Lehman Brothers Real Estate Partners III**

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 proposed real estate investment of: \$100 million in the Lehman Brothers Real Estate Partners III ("LBREP III"). This investment was included in the materials for the February 21, 2007 Council meeting, but it was tabled given there was not a quorum available for presentation of the proposal (note: one Council member present for the February meeting had recused himself on this investment).

Please note that this investment will be authorized pursuant to Articles 69 and 71 of the Council's regulations. The recommended investment will be considered "non-core real estate" investment as defined under N.J.A.C. 17:16-71.1.

The Alternative Investments Procedures adopted by the Council on February 21, 2008 require any potential alternative investment opportunities to be identified and initially evaluated by the applicable staff of the Division of Investment ("DOI") and the applicable Asset Class Consultant (The Townsend Group for Real Estate, or "Townsend") in coordination with the Division of Investment's Investment Committee (Director, Deputy Director and the senior staff member for the applicable alternative asset class).

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 meets the criteria for investments set forth in the Alternate Investment Procedures.

Lehman Brothers Real Estate Partners III (“LBREP III”) is a \$4-5 billion global high return follow-on fund to the very successful 2001, \$1.6 billion Lehman Brothers Real Estate Partners I (“LBREP I”) and the \$2.4 billion, 2005 vintage Lehman Brothers Real Estate Partners II (“LBREP II”) sponsored by the Global Real Estate Group (“GREG”) of Lehman Brothers Holdings Inc. (“Lehman” or the “Manager”), a publicly-listed (NYSE:LEH) global investment bank that offers investment banking, sales and trading, equity research, private equity, and debt issuance. Lehman is making an \$800 million commitment to LBREP III.

LBREP III is targeting net returns of 18% (25% gross) with 65% leverage on average and intends to invest across all asset classes including: commercial (primarily office with limited retail and industrial exposure), residential (mostly for-sale in Central and Eastern Europe and Asia), multifamily, hospitality and specialty sectors. LBREP III will also target smaller operating platforms and larger mixed-use portfolios or a combination of these asset classes.

Historically, Lehman is a “Global Asset Allocator” that prefers to follow a bottom-up, deal driven approach not a thematic investor that targets specific regions, countries or property types. The LBREP III strategy will focus primarily on smaller and middle market transactions, mostly in hard assets, and executed almost exclusively through the use of local operating partners. The proposed geographic targets for the Fund are 30% North America, 40% Europe and 30% Asia, although as highlighted earlier, this is subject to change based on deal flow. Lehman can invest up to 20% of the Fund outside of these three regions.

LBREP III will have access to the dedicated private equity team of over 100 professionals, including 43 Principals, and will be further supported by over 450 professionals within the various business units of GREG. LBREP III will utilize Lehman’s deep network of banking relationships with large corporate and retail clients to source deals and to team with local operating partners. Prior funds with the same management team have been hugely successful: LBREP I is projected to generate a 38% gross IRR (30% net of fees) while LBREP II is currently projecting a 32% gross IRR (23% net). Over 75% of investment returns in both funds have exceeded a 20% IRR.

All the legal and economic terms associated with LBREP III are fair and consistent with market standards.

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 the proposed investment to the full Council pursuant to Step 3 of the

State Investment Council

March 14, 2008

Page 3

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 this 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 the general partner.

We look forward to discussing this proposed real estate investment at the Council's March 20, 2008 meeting.

WGC/lt

Attachment