Real Estate Portfolio Overview

Consultant Report

Update as of

March 31, 2012

Prepared by

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Table of Contents

Portfolio Review 3
Glossary...5

Portfolio Review

This report provides an overview of the CalPERS Real Estate portfolio (the Portfolio) for the quarter ending March 31, 2012[i]. The policy analysis compares the Portfolio to the Real Asset Policy dated August 15, 2011. Certain portfolio limits and parameters for the Portfolio have interim ranges that will change periodically until July 1, 2015 when the long term strategic policy limits will be in place. The report gives an overview of the following:

- returns;
- risk exposure;
- leverage;
- commitments; and
- Real Estate Investment Committee (REIC) activity.

The following bullet points summarize the key events and metrics characterizing the CalPERS Real Estate Portfolio as of March 31, 2012:

- As of March 31, 2012, the Portfolio had a net asset value (NAV) of $21.1 billion, representing approximately 8.9% of the total CalPERS investment portfolio. The size of the Portfolio is within the allocation range of 7% to 13%, and effectively at the 9% interim target. It is important to note that the target allocation was revised by the Investment Committee in August of 2011 from 10% to 8% through the period ending December 31, 2011 and then to 9% through the period ending December 31, 2012 and 10% thereafter.
- Returns for the Portfolio outperformed the Policy Benchmark as calculated and presented in the Quarterly Performance Report (QPR) for the quarter and one-year period and underperformed the Benchmark for all of the longer measurement periods analyzed. The positive returns over the shorter term continue the positive trend started in the third quarter of 2010. During the ten-year period, the Portfolio yielded nominal, after fee, total returns of 2.5%, comprised of 1.8% income and 0.7% appreciation[1], compared to the Policy Benchmark total return of 9.0%. Low interest rates, and correspondingly low capitalization rates, have translated into write-ups in value for many properties during the past eighteen months from the nadir of valuations recorded during the recession.
- The Portfolio is in compliance with all investment policy guidelines.
- Many current Portfolio investment holdings are based on commitments made by CalPERS in 2005 and 2006. Therefore, the Portfolio has significant vintage year exposure to investments made between 2005 and 2008. Given the heated market conditions during this time period, the subsequent decreases in valuations from original cost have had a negative impact on the Portfolio's returns.

1 Differences in the sum of income and appreciation to the total return may be due to rounding or linking.

- PCA has recommended, and is working with Staff to clarify how vintage year exposure is calculated in AREIS (CalPERS' asset management information system) and can be best reported.
- The Portfolio is in compliance with leverage policy guidelines. The Portfolio loan to value ratio (LTV) is 42.3% versus the policy limit of 60.0%. Over the past year leverage has declined from 48.9% to 42.3% because of repayments of debt and increased appraised values.
- The Portfolio recourse debt as of March 31, 2012 is in compliance with the policy limit. The $1.3 billion of recourse debt is below the policy limit by $778 million. The recourse debt has decreased by $496 million since March 31, 2011. Reduction of recourse debt continues to be a priority of the deleveraging program initiated in 2009.
- As of the March 31, 2012 reporting period, the Portfolio's debt service coverage ratio (DSCR) of 2.2 continues to be in compliance with the policy guidelines.
- Approximately $5.3 billion of debt will mature by December 31, 2013, representing 37% of the Portfolio's total outstanding debt.
- In the quarter ending March 31, 2012, the Real Estate Investment Committee (REIC) committed $1.1 billion of new capital to existing partners. The REIC approved the use of $41.1 million of debt financing. The REIC did not authorize any dispositions. The REIC did not authorize any due diligence. The REIC declined seven investment offerings.

Glossary

After Fee Performance Objective and Benchmark - The performance objective of the Portfolio is to meet or exceed (after fees) a minimum real rate of return of 5.0%.

Appreciation Return – Expressed as a percentage, the change in market value over the period of analysis. The appreciation return is computed as follows:

$$\left[\frac{\text{Realized + Unrealized Gain or Loss}}{\text{Beginning Net Assets + Time-Weighted Contributions - Time-Weighted Distributions}} \right] \times 100$$

Before Fee Performance Objective and Benchmark - The proposed interim Real Estate benchmark is a composite of the NCREIF ODCE and the previous global equity REIT index (FTSE EPRA NAREIT Global). Each quarter, the benchmark weight of the REIT index weight would equal the actual weight of the REIT portfolio at the end of the prior quarter. The portfolio REIT allocation, 7%, as of April 2011 is expected to decline to zero over the next one to three years. This transition plan is gradual and responsive to market conditions.

Capitalization Rate – Any rate used to convert income into value. Value conversion formula is as follows:

Net Operating Income/Capitalization Rate = Real Estate Value

Core Risk Classification – The Core risk classification includes investments that produce a predictable current net income yield after debt service. Typically Core assets shall exhibit institutional qualities that are well located within their local and regional markets and of high quality design and construction. Core assets shall include investments located only in Developed Markets. Core assets shall have low leverage and generally low risk/return profiles.

Core assets shall be limited to traditional property types: Office, Retail, Industrial, Multifamily, and Hotels. Mixed use projects incorporating the traditional product types are also acceptable.

All Public Real Estate Securities shall be considered Core.

Credit Accommodation - Credit accommodation generally refers to a guaranty executed by CalPERS whereby CalPERS agrees to pay the debt obligation of an entity, in the event the entity fails to pay the debt obligation. The entity will usually be a limited partnership or limited liability company, and will be majority-owned by CalPERS. The debt obligation that CalPERS guarantees will be evidenced by an extension of credit (e.g., loan, line of credit, or other form of credit facility) by a financial institution to the entity. The benefit provided to CalPERS is that the guaranty will tend to lower the

borrowing cost for the entity and should, in turn, enhance the overall return to the real estate investment. Guarantees become a contingent liability on the CalPERS overall balance sheet and should be used only when they provide economic benefit. Credit accommodation differs from credit enhancement in that a credit accommodation does not derive its rating from the CalPERS Credit Enhancement Program (CEP) rating (either implied or explicitly). In addition, Credit Accommodation is made for an entity in which CalPERS has an existing, or proposed, ownership interest. Credit enhancement is the use of CalPERS balance sheet, through the program rating, in which CalPERS has no initial ownership interest and where CalPERS receives explicit consideration for the enhancement.

Debt Service Coverage Ratio (DSCR) – The annual net operating income divided by the annual debt service.

Developed Markets – As defined by the FTSE Global Equity Index Series.

Emerging Markets – As defined by the FTSE Global Equity Index Series as “Advanced Emerging” or “Secondary Emerging”.

For Sale Residential & Land Development – Assets categorized as Housing and Undeveloped Land exclusive of Agricultural and Vineyards.

Frontier Markets – Countries not defined by the FTSE Global Equity Index Series as “Developed”, “Advanced Emerging”, or “Secondary Emerging”.

Income Return – Expressed as a percentage, income accrued divided by beginning net assets adjusted for time-weighted contributions and distributions. The income return is computed as follows:

$$\left[\frac{\text{Investment Income}}{\text{Beginning Net Assets} + \text{Time-Weighted Contributions} - \text{Time-Weighted Distributions}}\right] \times 100$$

Internal Rate of Return (IRR) – Dollar weighted rate of return that shows profitability as a percentage, showing the return on each dollar invested. IRR equates the present value of a partnership's estimated cash flows (CF) with the present value of the partnership's costs. Before fees (BF) IRR is calculated before all expensed fees such as Asset Management, Disposition, Incentive Fees, etc. After fees (AF) IRR is calculated after all expensed fees such as Asset Management, Disposition, Incentive Fees, etc. Please note, IRR for CalPERS reporting purposes is calculated for sold/realized projects only.

IRR is the quarterly discount rate that makes the following relationship hold:

Present Value (inflows) = Present Value (investment costs)

IRR is computed as follows:

$CF_0 + CF_1 / (1+IRR) + CF_2 / (1+IRR)^2 + CF_3 / (1+IRR)^3 \ldots CF_n / (1+IRR)^n = 0$

Investment Fees – Generally include acquisition, asset management and disposition fees paid to third party firms. Acquisition and disposition fees are calculated on a per transaction basis and range from 0 to .85 percent and 0 to .60 percent, respectively, on a graduated scale. Asset management fees are based on asset value and range from .25 to .65 percent on a graduated scale.

Multifamily Property Type – includes assets classified under the categories Apartment

Net Asset Value (NAV) – A term used to describe the value of an entity's assets less the value of its liabilities.

Nominal Returns – Nominal returns are unadjusted for inflation.

Opportunistic Risk Classification – The Opportunistic risk classification includes assets that have the expectation to produce substantial capital appreciation and higher yields. Current income may be low or non-existent during the holding period of the asset. Opportunistic investments often exist because of inefficiencies in real estate or capital markets. The Opportunistic risk classification shall include investments with assets located in Developed, Emerging, and Frontier Markets. Investments in land shall be categorized as opportunistic. Opportunistic investments may have high leverage and high risk/return profiles.

Other Property Type – includes assets classified under the categories, of Agricultural Land, Entertainment, Healthcare, Other, Self Storage, Senior Housing, Technology, and Vineyards.

Real Estate Investment Trust (REIT) – Similar to a mutual fund, a REIT is a corporation or trust that combines the capital of many investors to acquire or provide financing for all forms of real estate.

Real Returns – Nominal returns adjusted for inflation as follows:

$$\left[\frac{1 + \text{Nominal Return}}{1 + \text{Inflation}} \right] = 1 + \text{Real Return}$$

Realized Appreciation – For assets which are sold, the appreciation is realized.

Recourse Debt – Debt for which CalPERS has the obligation (direct or indirect, absolute or contingent) to pay the debt to the lender. Debt that may be recourse to a Separate Account or a Commingled Fund or a Joint Venture but for which CalPERS has no obligation will be treated as non-recourse debt for the purpose of this Policy.

Subscription Financing – Subscription financing is a form of leverage in which debt incurred by an investment partnership is secured by the capital commitment of an investor, which may be used to pay the debt for the investment partnership.

Time-Weighted Contributions – The amount of capital CalPERS contributes to a property/investment during a quarter adjusted for the amount of days left in the quarter at the time of the transaction. The computation is as follows:

$$\left[\frac{(\text{Contrib.1} \times \text{Days to End of Quarter}) + (\text{Contrib.2} \times \text{Days to End of Quarter}) + (\ldots)}{\text{Days in Quarter}} \right]$$

Time-Weighted Distributions – The amount of cash received by CalPERS from a property/investment during the quarter adjusted for the amount of days left in the quarter at the time of the transaction. The computation is as follows:

$$\left[\frac{(\text{Distrib.1} \times \text{Days to End of Quarter}) + (\text{Distrib.2} \times \text{Days to End of Quarter}) + (\ldots)}{\text{Days in Quarter}} \right]$$

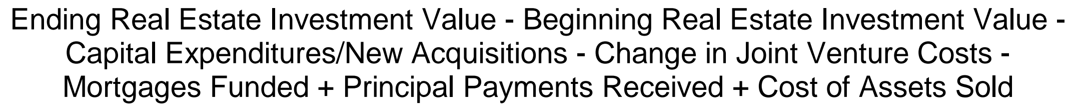
Time-Weighted Return – Expressed as a percentage, the change in market value plus the income or loss over the period of analysis. The time weighted return is computed as follows:

$$\left[\frac{\text{Income} + \text{Unrealized Gain or Loss} + \text{Realized Gain or Loss}}{\text{Beginning Net Assets} + \text{Time-Weighted Contributions} - \text{Time-Weighted Distributions}} \right] \times 100$$

Time-Weighted Return (Calculations) – Performance calculations do not include trailing activity related to sold assets before June 30, 2009. Trailing activity is included for assets sold after July 1, 2009.

Unrealized Appreciation – For assets which continue to be held, the appreciation is unrealized. When assets are sold, the appreciation is realized.

Unrealized Gain or Loss – The change in market value of a real estate asset over the period of analysis adjusted for several factors. The computation is as follows:



Ending Real Estate Investment Value - Beginning Real Estate Investment Value -
Capital Expenditures/New Acquisitions - Change in Joint Venture Costs -
Mortgages Funded + Principal Payments Received + Cost of Assets Sold

Value Add Risk Classification – The Value Add risk classification includes assets that have the expectation to produce a predictable current net income yield after debt service within a reasonable time frame, typically one to three years. Capital investment may be required to develop, lease, redevelop, or renovate the assets. Value Add assets may have moderate leverage and moderate risk/return profiles.

The Value Add risk classification shall include investments located primarily in Developed Markets. Stabilized (Core like) private assets in Emerging Markets shall be considered Value Add.

[i] Pension Consulting Alliance, Inc. (PCA) prepared this document solely for informational purposes to assist the Investment Committee of the California Public Employees' Retirement System (CalPERS) in its ongoing property investment program. To the extent that market conditions and CalPERS' policies change subsequent to the date of this report, PCA retains the right to change the views contained herein.

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Due to rounding, some totals might not appear to be equal to the sum of their parts.

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