Real Estate Portfolio Overview

Consultant Report

Update as of

June 30, 2012

Prepared by

Pension Consulting Alliance, Inc.

Los Angeles • Portland • New York

CONFIDENTIAL

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 June 30, 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 June 30, 2012:

- As of June 30, 2012, the Portfolio had a net asset value (NAV) of $21.5 billion, representing approximately 9.2% of the total CalPERS investment portfolio. The size of the Portfolio is within the allocation range of 7% to 13%, and above 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 one-year period and underperformed the Benchmark for all other measurement periods analyzed. During the ten-year period, the Portfolio yielded nominal, after fee, total returns of 2.5%, comprised of 1.7% income and 0.7% appreciation[1], compared to the Policy Benchmark total return of 9.1%. Low interest rates, and correspondingly low capitalization rates, have translated into increases in appraised 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.
- 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.

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

- The Portfolio is in compliance with leverage policy guidelines. The Portfolio loan to value ratio (LTV) is 40.8% versus the policy limit of 60.0%. Over the past year leverage has declined from 47.0% to 40.8% because of repayments of debt and increased appraised values.
- The Portfolio recourse debt as of June 30, 2012 is in compliance with the policy limit. The $615 million of recourse debt is below the policy limit by $1.5 billion. The recourse debt has decreased by $1,729 million since June 30, 2011. Reduction of recourse debt continues to be a priority of the deleveraging program initiated in 2009.
- As of the June 30, 2012 reporting period, the Portfolio's debt service coverage ratio (DSCR) of 2.2 continues to be in compliance with the policy guidelines.
- Approximately $3.7 billion of debt will mature by December 31, 2013, representing 26% of the Portfolio's total outstanding debt.
- In the quarter ending June 30, 2012, the Real Estate Investment Committee (REIC) committed $4.0 billion of new capital to existing partners through the Annual Investment Plan (AIP) process. The REIC approved the use of $1.4 billion of new debt financing and $1.1 billion of refinancing/early payoff of debt through the AIP process. The REIC authorized $1.3 billion in dispositions through the AIP process. The REIC did not authorize any due diligence. The REIC declined 31 investment offerings.

Glossary

Real Estate Subportfolio and Strategy Classifications

Real Estate Objective and Role – As described in the Real Assets Statement of Investment Policy effective August 15, 2011, the role for Real Estate is to:

1. Provide a low correlation to equities in the overall CalPERS Investment Portfolio

2. Generate stable cash yields primarily for CalPERS

3. Provide a hedge against inflation

Legacy Subportfolio – Assets that do not fit the objective/role of Real Estate. . Legacy assets will be managed to optimization.

Strategic Subportfolio – Assets that fit the objective/role of Real Estate. The Strategic Subportfolio is comprised of 3 Strategies: Base, Domestic Tactical, and International Tactical.

1. Base Strategy – The objective of the Base Strategy is generation of stable cash flows (i.e. concentration on the Income component of the Total Return) within a long-term hold strategy and structure. It will be comprised of stabilized, high quality, Core assets in high quality U.S. primary market locations.

2. Domestic Tactical Strategy – The objective of the Domestic Tactical Strategy is to focus on total return, which includes a blend of income and appreciation components. Individual investments may have Core, Value Add, and Opportunistic risk profiles, but the Domestic Tactical Strategy as a whole will have a risk target between Core and Value Add. It will be comprised of stabilized, development, and repositioning/distressed assets in the Unites States.

3. International Tactical Strategy – The objective of the International Tactical Strategy is to focus on total return, which includes a blend of income and appreciation components. Individual investments may have Core, Value-Add, and Opportunistic risk profiles, but the International Tactical Strategy as a whole will have a risk target between Value-Add and Opportunistic. It will be comprised of stabilized and development ex-U.S./Emerging Market assets.

Benchmarks

Real Estate Program – The historical composition of the Real Estate Program Benchmark is the following:

July 1, 1982 through June 30, 2008 – 100% NCREIF Property Index (NPI)

July 1, 2008 through June 30, 2011 – 90% weighted to the NPI + 200 BPS and 10% weighted to the FTSE EPRA NAREIT Global Return Index

July 1, 2011 through Present – NCREIF Fund Index Open-End Diversified Core Equity (ODCE), Net of Fees.

Currently there is an interim Real Estate Program Benchmark, which is a composite of the NCREIF ODCE Index and the FTSE EPRA NAREIT Global Index. The benchmark weight of the REIT index equals the actual weight of the REIT portfolio at the end of the prior quarter. If and when the REIT allocation goes to zero, the NCREIF ODCE Index will become the Real Estate Policy Benchmark.

Definition of Terms

Annualized – When returns for a period other than one year are put on an annual basis. For example, an individual quarter return would be annualized as follows:

[(1+Quarter Return)^4] – 1 = Annualized Return

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

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

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

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

Net Operating Income/Capitalization Rate = Real Estate Value

Compounding – Returns are geometrically compounded on a quarterly basis. For example, the annual return for four quarters would be:

(1 + Q1)(1 + Q2)(1 + Q3)(1 + Q4) = (1 + Annual Return)

Credit Accommodation – The term 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 for 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 is not rated and does not use 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.

Discount Rate – A yield rate used to convert future payments or receipts into present value.

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. After fees (AF) IRR is calculated after all expensed fees such as Asset Management, Disposition, Incentive Fees, etc. Please note, for CALPERS reporting purposes, it is assumed that Partnership Contributions (outflows from CALPERS) and Distributions (inflows into CALPERS) represent net amounts, after all fees have been accounted for.

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.

J-Curve Effect – Refers to the shape of a plotted trend line depicting investment returns produced from the common practice of paying management fees and start-up costs out of the first draw on committed capital. As a result, a fund will initially show a negative return. When the first realizations are made, the fund returns start to rise steeply. After about three to five years, the interim return will give a reasonable indication of the definitive return.

Market Value – An opinion of value as of a certain date as stated by either the investment advisor or independent appraiser. Market value differs from amount funded or net investment in that the value includes unrealized potential gains or losses during the holding period.

Net Assets (Market Value) – Total assets minus liabilities based on market value.

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

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

Net Investment Income – The amount of net income that has accrued for the period, net of advisor fees.

Nominal Returns – Nominal returns are unadjusted for inflation.

Other Credits – (as shown on the Real Assets Continuity Schedule) - Comprised of foreign currency translation gain/loss, minority interest adjustments, and other comprehensive income.

Property Type – Eleven property type categories are used throughout the report.
A property is placed into a category based on its primary use, unless otherwise designated as a mixed-use property.

Realized Gain or Loss – The gain or loss CalPERS realized from the disposition of a real estate asset. The computation is as follows:

Proceeds from Investments Sold – Cost of Investments Sold – Recognized Prior Period Appreciation on Investments = Realized Gain or Loss

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 Estate Investment Value – The sum of components of real estate investments at fair value. REIV is computed as follows:

(Equity + Capital Expenditures) + Mortgages Receivable + Debt/Equity

Real Returns – Nominal returns adjusted for inflation as follows:

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

The Consumer Price Index – Urban (CPI-U) is used for the inflation factor.

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:

$$\frac{(\text{Contrib.1 x Days to End of Quarter}) + (\text{Contrib.2 x Days to End of Quarter}) + (\ldots)}{\text{Days in Quarter}}$$

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:

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

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.

Total Net Return – The sum of the net income return and the appreciation return.

Unrealized Gain or Loss – The change in market value of a real assets 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

CONFIDENTIAL

---

[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.

PCA prepared this document and the analyses contained in it based, in part, on certain assumptions and information obtained from sources affiliated to CalPERS, including, without limitation, investment advisors, investment managers, consultants, CalPERS staff and third-party providers. PCA's use of such assumptions and information does not imply that PCA independently verified or necessarily agrees with any of such assumptions or information. PCA assumed and relied upon the accuracy and completeness of such assumptions and information for purposes of this document. Neither PCA nor any of PCA's affiliates, or PCA's or their respective officers, employees or agents, make any representation or warranty, express or implied, in relation to the accuracy or completeness of the information contained in this document or any oral information provided in connection herewith.

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

Pension Consulting Alliance, Inc. All rights reserved.