



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Public Investment Memorandum

Latitude Management Real Estate Capital IV, Inc.

High Yield Commitment

Laurann H. Stepp
Senior Portfolio Manager

April 29, 2016



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Recommendation:

Staff, together with Courtland Partners, recommends to the Board a commitment of up to \$75 million to Latitude Management Real Estate Capital IV, Inc. ("Fund", or "LMREC IV"). Latitude Real Estate Investors, Inc. ("Latitude", or "LMREI"), a Los Angeles headquartered private investment firm, is sponsoring the Fund to primarily originate short-term, floating rate first mortgage debt.

Latitude Overview:

Latitude Management Real Estate Capital was formally known as Legg Mason Real Estate Investors. They became Latitude in April 2009 when current management bought out their division from Legg Mason, who exited the real estate business. LMREI invests domestically as a real estate debt and equity fund manager. Their primary business is managing debt funds, which represent 85% of their \$1B in assets under management. They also invest equity opportunistically in value-add multi-family or hospitality properties, and provide advisory services for some private investors.

The firm currently has 23 employees, including 21 investment professionals. All departments operate out of their Los Angeles headquarters, although one Managing Director heavily focused on acquisitions spends half his time in a Denver office. The newest addition to the Managing Partner ranks joined the firm 7 years ago, and the other three Senior members have worked together over 11 years.

Investment Strategy:

Approximately 95% of fund will be 3-4 year first mortgages of \$5-\$35 Million, against cash flowing, or soon to be cash flowing, real estate assets (excluding land, condos, construction and single purpose real estate) that are acquired with a value-add component. Investments are typically made with a loan to cost of 80%, except for multi-family which can go to 85% and hospitality which is limited to 75%. Floating rate portfolio leverage will be matched to the loans to the borrowers, with the requirement that borrowers purchase floating interest rate caps.

The Fund will build a diversified portfolio of single loans on smaller sized assets located in primary and secondary markets across the United States. The typical loan is with an experienced borrower purchasing an asset that needs capital improvements, leasing and improved management. These borrowers are sourced through LMREI long-term associations with brokers, and include repeat borrowers as well as referrals from borrowers. Latitude expects to allocate LMREC IV as follows, within the limitations and loan to cost limits identified:

Property Type	Allocation expected	Limitations	Loan to Cost limits
Multi-family	40-60%		85%
Primary and secondary market office	20-25%		80%
Hospitality	15-20%	25%	75%
Multi-tenant warehouse/industrial	5-15%		80%
Retail	0-5%	35%	80%

Investment Team:

The fund will be led by two founders, Glenn Sonnenberg and Chip Sellers, who have worked together for over 17 years. They are joined by two other Managing Directors, who each have over 21 years of real estate experience and have been with the firm for seven years and eleven years, respectively.

The team consists of 21 professionals with real estate, capital markets and management skills; located at the Los Angeles headquarters, with the exception of one Managing Director that is heavily focused on acquisitions and spends half his time in a central U.S. Denver office.



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Investment Instruments:

LMREC IV will originate floating rate first mortgage loans secured by US domestic real estate.

Investment Structure:

LMREC IV is a Delaware corporation owned by its shareholders and structured as a real estate investment trust (REIT).

The Manager of the Fund, LMREI, is a Maryland Corporation and a registered investment advisor with the SEC.

Market Opportunity:

The inventory of commercial real estate assets that needs to be recapitalized as part of the industry's reduction of outstanding debt remains at the same high levels as the last LMREI fund in 2012, and Latitude expects this situation to continue for years. Banks are no longer in the business of providing short term interim capital for value-add improvements due to their costly balance sheet holdings requirements. Properties that had been neglected, undercapitalized, or held in portfolios at banks or finance companies are selling to new owners who need interim capital to improve the property. Once the properties are stabilized there is ready, low rate financing available to them from multiple channels.

Given the continued low interest rate environment and steady U.S. economic recovery, the commercial real estate transaction volume continues to climb in all major property types.

Investment Highlights:

Experience in all real estate cycles
Understand importance of cash controls, restructuring, workouts and asset management. Bottoms-up underwriting with in-house ability to manage a foreclosed asset. Sixth debt fund created and managed by the Latitude team. Experience as lender, borrower, principal and bondholder enabling the ability to view deals from all aspects. This becomes especially critical during loan modifications, restructurings, foreclosures, and litigation.
Mid-size asset strategy, with an inefficient market that is not covered by mega funds
Primary competition is from finance companies, who are consistently reliable market participants. Other institutional capital providers tend to pursue loans in excess of 25M. The smaller loans tend to be to local entrepreneurs who have less access to a wide range of capital sources.
Market Knowledge, Sourcing
Loans are primarily privately negotiated, proprietary transactions sourced from their network of contacts. LMREI has a strong reputation of certainty of closing and flexibility with borrowers under time constraints. Loan pricing is not the controlling factor for this type borrower.

Investment Considerations:

Sustained decline in market values
The structure of a first mortgage protects the asset from the first 25% of a loss (assuming a 75% loan to value), and allows for the retention of the asset until the markets recover. Underwriting based on underlying collateral and property cash flow, along with active asset management will assist in efficient transition to REO (real estate owned) status and oversight.
Use of Leverage
Fund allows for up to 60% leverage during Investment Period, and 55% thereafter. Fund obtains leverage through two basic structures, CLO (collateralized loan obligation) and bank lines of credit. CLOs are employed when market conditions (including spreads) are favorable (as was the case in LMREC II and LMREC III). The CLO's include no mark to market margin call rights, no duration mismatches (leverage should match or exceed duration on loans being originated), matched rate indices (Libor), and the ability to contribute new assets over the term of the Investment Period (recycling) which reduces fund expenses associated with leverage and enhances the Fund's multiple return. When CLOs are unavailable, and when the Fund is building a portfolio, bank lines are



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

used. The bank lines have no mark-to-market margin call rights with respect to economic and real estate market movement (but will have limited margin call rights related specifically to collateral level underperformance), no duration mismatches for initial loan terms and matched rate indices. In February 2015 Fund III was the first issuer of a managed real estate debt CLO since the global financial crisis.

Changes to Libor and/or interest rate spreads

The loans to Borrowers are typically Libor based, plus a market spread and fees. In certain market situations the market spread may widen or narrow, and Libor rates may rise or lower. LMREI requires its borrowers to purchase and pledge interest rate caps to help hedge against rising rates and minimize any negative impact.

PSERS History & Performance:

Since 2002, PSERS has committed \$232.6 million to three LMREC Funds. The following table summarizes PSERS' historical performance with Latitude's funds as of December 31, 2015:

Fund (\$M)	Vintage	Fund Size	Commitment	Contributions	Distributions	NAV	Net IRR	MOIC	Projected Net IRR	Projected MOIC
LMREC I	2002	231.0	57.6	56.9	57.8	0	0.6%	1.02x		Liquidated April, 2015
LMREC II	2005	455.1	100.0	97.5	101.8	36.8	6.4%	1.42x	6.4%	1.44x
LMREC III	2012	404.7	75.0	70.3	8.6	72.6	10.0%	1.15x	10.9%	1.59x
PSERS Total			\$232.6	\$224.7	\$168.2	\$109.2	5.6%	1.24x		

Portfolio Fit:

A commitment to LMREC IV will be allocated to the Real Assets bucket of PSERS' High Yield portfolio. As of September 30, 2015, the High Yield portfolio (based on total exposure) was allocated 52% Opportunistic, 26% Senior Loans, 14% Mezzanine and 7% Real Assets.

The table below summarizes PSERS' projected exposure inclusive of a recommended \$75 million commitment to the Fund:

Investment Type (\$mm)	Active Commitments ¹	%	Market Value	%	Unfunded ¹	%	Total Exposure ¹	%
Opportunistic	\$ 4,073.6	49.5%	\$ 1,630.7	53.2%	\$ 1,765.0	52.3%	\$ 3,395.7	52.7%
Senior Loans	2,665.0	32.4%	754.2	24.6%	854.1	25.3%	1,608.4	25.0%
Mezzanine	871.4	10.6%	369.6	12.1%	525.8	15.6%	895.4	13.9%
Real Assets	626.2	7.6%	311.8	10.2%	227.2	6.7%	539.0	7.3%
Total	\$ 8,238.2	100.0%	\$ 3,066.3	100.0%	\$ 3,372.1	100.0%	\$ 6,438.4	100.0%

¹ Includes post Q3'2015 pending/closed commitments

Liquidity & Leverage Profile:

The Fund is expected to be invested within three years of its final closing, and will have the ability to recycle proceeds for five years from final close, plus one year with the Advisory Board approval (the "Investment Period"). The Fund will make quarterly distributions, and is expected to generate current income returns of 10%.

LMREI will employ up to 60% fund-level leverage during the Investment Period, and 55% fund-level leverage thereafter.



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Finance Committee Disclosure:

Relationship with Courtland:	N/A
Placement Agent:	Wren Capital, Not used for PSERS commitment
PA Political Contributions:	None Disclosed
PA Presence:	No
Conflicts:	None Disclosed
First Time Fund With PSERS:	No
PSERS Internal Alpha Committee Approval:	February 9, 2016

Oversight Responsibility:

Investment Office:	Charles J. Spiller Laurann H. Stepp	Deputy CIO, Non-Traditional Senior Portfolio Manager
External Consultant:	Courtland Partners	

COURTLAND PARTNERS, LTD.
INSTITUTIONAL REAL ESTATE SERVICES

127 PUBLIC SQUARE
SUITE 5050
CLEVELAND, OH 44114

TELEPHONE: (216) 522-0330
FAX: (216) 522-0331
www.courtland.com

April 29, 2016

Board of Trustees
Commonwealth of Pennsylvania,
Public School Employees' Retirement System
5 North 5th Street
Harrisburg, PA 17101

Re: Latitude Management Real Estate Capital IV, Inc.

Dear Trustees:

Courtland Partners, Ltd. ("Courtland"), having been duly authorized by the Board of PSERS, has evaluated Latitude Management Real Estate Capital IV, Inc ("LMREC IV" or the "Fund"). LMREC IV's investment strategy is to originate short term (three to five year) floating rate first mortgage bridge loans on transitional value-add commercial property. The Fund will focus on smaller-sized assets (\$5 to \$35 million loans) located in primary and secondary markets, and cash flowing or soon to be cash flowing assets (no land, construction loans, or single tenant risks). The Fund will target multifamily, multi-tenanted office, multi-tenanted industrial, limited service hospitality, and grocery anchored and urban in-fill multi-tenant retail property types. The assets must be fundamentally sound, but underperforming their peer group for reasons easily addressed by competent borrowers.

Latitude will implement the Fund's strategy by targeting high quality assets with high quality investment sponsorship. Latitude's focus is on primary and secondary markets exhibiting positive growth in employment and demographics. LMREC IV will invest exclusively in the United States, with a geographic focus in the Southeastern and Southwestern markets. No more than 40% of the Fund will be lent in one NCREIF geographic region. Latitude anticipates that the property type diversification for the fund will be 40-60% multifamily; 20-25% primary and secondary market office; 15-20% hospitality; 5-15% multi-tenant warehouse, distribution, and industrial; and 0-5% retail.

Latitude's pipeline remains robust and has been expanding; velocity supports origination of approximately \$40,000,000 of new loan originations per month. Latitude believes that there is strong demand for the type of first mortgage bridge loans it originates. Over 85% of Latitude's financing are new acquisitions purchased by institutional ownership acquiring from less institutional, local, or idiosyncratic ownership. Typically the new owner is attempting to "right the ship" via capital improvements, leasing, and improved management prior to locking in long term fixed rate financing.

Latitude relies on its reputation and track record with the outside mortgage broker community to source potential investments. Latitude has established its reputation over the last 17 years and considers it one of Latitude's greatest assets. Latitude attributes its strong reputation in the mortgage broker community to its certainty of closing, flexibility, and market knowledge. Latitude markets to its established broker networks by attending lending conferences as well as regular face to face meetings on a nationwide basis. New investments are frequently sourced from markets in which the Manager has already transacted business, as a result of past closing successes.

COURTLAND PARTNERS, LTD.

LMREC IV

Courtland's recommendation is based upon the following factors and is made with the understanding that the investment, if approved, will be placed into PSERS' debt portfolio, rather than into the real estate portfolio.

- Detailed due diligence, including interviews with key Latitude management team members, and review of all relevant materials provided by Latitude.
- Evaluation of the Fund's proposed investment strategy within the context of the current investment environment.
- Evaluation of Latitude's track record and organizational resources.
- Discussion and review of the market conditions in markets relative to the proposed investment strategy.
- The recommendation is subject to approval by PSERS, confirming that the investment criteria for the debt portfolio have been met.

Based on the above, Courtland recommends that PSERS commit up to \$75 million to the Fund. Courtland makes this recommendation considering Latitude's qualifications and PSERS' overall investment guidelines.

This recommendation is given solely for the benefit of PSERS and cannot be relied upon by other investors considering an investment in the Fund, since their needs, objectives and circumstances may not be identical to those of PSERS. The scope of this recommendation is limited to the investment merits of the Fund. Courtland does not provide legal or other non-investment-related advice.

Sincerely,



Steven Novick
Principal-Chief Operating Officer

COURTLAND PARTNERS, LTD.

COURTLAND PARTNERS, LTD.