



State of New Jersey

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Governor

DEPARTMENT OF THE TREASURY
DIVISION OF INVESTMENT
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Lt. Governor

ANDREW P. SIDAMON-ERISTOFF
State Treasurer

May 11, 2011

MEMORANDUM TO: New Jersey State Investment Council

FROM: Timothy Walsh
Director

SUBJECT: **Proposed Investment in Lone Star Fund VII (U.S.), L.P.**

The New Jersey Division of Investment is proposing an investment of \$300 million in Lone Star Fund VII (U.S.), L.P. This memorandum is presented to the State Investment Council (the "Council") pursuant to N.J.A.C. 17:16-69.9.

The Division of Investment ("Division") Staff and its real estate consultant, The Townsend Group, undertook 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.

Lone Star Fund VII, comprised of Lone Star Fund VII (U.S.), L.P., and Lone Star Fund VII (Bermuda), L.P. (together, LSF VII) is a \$4.5 billion global opportunity fund. LSF VII will invest primarily in single family residential loans and mortgage backed securities products, corporate and consumer debt products, financially-oriented operating companies, and operating companies with significant tangible assets. Lone Star estimates that 70% of the LSF VII will be invested in North America; approximately 20-25% is expected to be invested in Western Europe with the remaining 5-10% invested in Japan.

This investment combined with an investment in Lone Star Real Estate Fund II (U.S.), L.P. will reduce our management fee to 90 bps with a 10% preferred return and a 45 bps management fee post the investment period. Our combined commitment will also provide us an advisory board seat on both funds. Lone Star and its previous affiliates have raised eight prior funds. The prior funds have collectively invested/committed approximately \$24.7 billion of partnership equity.

LSF VII's investment strategy in the United States will principally target residential whole loans and residential mortgage backed securities (RMBS). In Europe, LSF VII is targeting three primary strategies: financial

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institutions (40-50%), corporate debt (25-30%) and residential securities and whole loans (25-30%).

In Japan, LSF VII sees opportunities in corporate distressed debt with secured assets, non-strategic assets from downsizing companies, consumer debt purchases from consumer finance companies and purchasing banks with government assistance.

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 each investment. In addition, each proposed investment must comply with the Council's regulation governing political contributions (N.J.A.C. 17:16-4).

Please note that these investments are authorized pursuant to Articles 69 and 71 of the Council's regulations. Lone Star Fund VII will be considered a non-core real estate investment, as defined under N.J.A.C. 17:16-71.1.

Formal written due diligence reports for the proposed investments were sent to each member of the Investment Policy Committee and a meeting of the Committee was held on May 5, 2011. In addition to the formal written due diligence reports, all other information obtained by the Division on the investment was made available to the Investment Policy Committee.

We look forward to discussing the proposed investments at the Council's May 19, 2011 meeting.

Attachments

***SIC Investment Committee Fund Review Memo**

To: State Investment Council
From: SIC Investment Committee
Date: May 19, 2011
Subject: Real Estate Investment Recommendation

Fund Facts

Fund Name:	Lone Star Fund VII
Fund Type:	Co-mingled
Current Fund Offering:	\$300 million
Current Fund Size/Vintage:	Fund VII -- \$4.5 billion
Previous Fund Size/Vintage:	Fund VI -- \$7.5 billion/ 2007
Final Close:	May-11
Fund Address:	2711 N. Haskell Avenue, Suite 1700 Dallas, TX 75204

GP Contact Info

Name:	Louis Paletta, Executive Vice President
Telephone:	(214) 754-8300

Summary of Terms and Investment Strategy

Investment Strategy:	Opportunistic/ Single family residential loans and mortgage backed securities products, corporate and consumer debt products, financially-oriented operating companies, and operating companies with significant tangible assets.
Geographic Focus:	US/Europe/Japan
GP Co-Investment Amount:	1% of total commitments
Terms:	
Term:	Ends May 2019 with two 1-year extensions at General Partner's Discretion
Investment Period:	3 years from final closing
Management Fee:	90 bps during investment period/ 45 bps thereafter on outstanding invested capital achieved through aggregate of \geq \$400 million to LSF VII and LSREF II combined
Preferred Return:	10% achieved through aggregate of \geq \$400 million to LSF VII and LSREF II combined
Catch Up:	80%/20% LP/GP split up to a 13% return 50%/50% LP/GP split after a 13% return up to a 20% return 80%/20% LP/GP split thereafter
Back Office/Service:	Hudson Advisors/Vericrest Financial
Fund Attorney:	K&L Gates LLP
Auditor:	Ernst & Young

NJ AIP Program:

Recommended Allocation Current:	\$300 million
% of investment in Fund VII:	6.7%

LP Advisory Board Membership:	Yes
Consultant Recommendation:	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.