

**COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**

DATE: January 19, 2006

SUBJECT: ProLogis – Open-End Core Fund

TO: PSERS' Finance Committee/Board

FROM: Charles J. Spiller
Director of Alternative Investments

PSERS staff and PSERS real estate consultant, Courtland Partners, are recommending that a \$200 million commitment be made to the new ProLogis North American Industrial Fund, L.P.

Fund Structure

The ProLogis North American industrial Fund, L.P. is considered an Open-End Core commingled industrial real estate fund. The ProLogis REIT, a leading global industrial real estate owner, operator, and developer, is the sponsor the fund. The Fund is being initially created by the contribution of \$810 million of stabilized assets. The Fund's strategy is to use its exclusive access to ProLogis' development pipeline in the U.S. and Canada as its major source of stabilized deals. While the focus is to utilize stabilized development projects coming out of the ProLogis REIT, the fund will have a small % of its allocation directed at related acquisitions that were not developed by ProLogis. The ProLogis REIT will commit to a 20% minimum co-investment into the Fund. There is a 2-year lockup for investors into the Fund.

Fund Specifics

The Fund is targeting total equity commitments to reach \$1.5 billion, including the ProLogis investment. The targeted return to investors is a 6.0%-6.5% average cash yield and a 10% leveraged IRR. Being an Open-End fund, it has an infinite life. Leverage is expected to range from 55% - 60% loan to value on average. The investment period anticipates equity deployment within three years. The annual asset management fee is tiered, and is set at 0.85% for a \$200 million commitment. In addition, ProLogis would receive an incentive participation fee equal to a 15% promote after investors achieve a 9% leveraged IRR, measured every three years. The Fund will have an Advisory Council

consisting of unaffiliated limited partners. Distributions are projected to be approximately average 7% over five years.

Seed Portfolio

The pre-identified \$810 million core portfolio totals 12.4 million square feet in 78 buildings. The buildings are in 23 markets and on average 95.9% leased with an average lease of 7 years. ProLogis developed 67 of the 77 buildings. ProLogis currently has 41 properties under development totaling 11.7 million square feet and another 38 properties totaling 11.1 million square feet in planning. For future development, ProLogis has over 4 million acres of land that can accommodate over 70 million square feet of buildable space.

Asset Requirements

ProLogis is required to contribute every stabilized asset they develop to the Fund no later than 280 days after the date the relevant asset is stabilized. They are to be located in ProLogis' targeted U.S. and Canada markets. The cumulative weighted average initial cap rate must be at least 6.25%. To be considered stabilized, each asset must be at least 93% leased, substantially all construction completed, have a weighted average remaining lease term of at least three years, and no more than 50% of the rentable square footage built out with office finishes. New assets will go into the Fund at appraised value.

Fund Management

The same staff that manages ProLogis' other investments will perform the management of these properties. Personnel do not distinguish between assets owned directly by ProLogis and those held in the fund. Employees spend 100% of their time on assets owned or co-owned by ProLogis. ProLogis does not manage properties in which it does not have an ownership stake. This approach allows properties under ProLogis management to benefit from various ProLogis-level initiatives, including an umbrella insurance policy and the establishment of a consistent product and branding.

ProLogis Track Record

ProLogis has an extensive demonstrated track record in institutional fund management. ProLogis has 2,293 distribution facilities serving over 4,100 customers in 76 markets. They have over 900 ProLogis associates around the globe. While they have \$17.6 billion in total market capitalization, \$9.7 billion of assets managed are in property funds. A merger with Catellus in mid-September increased the total assets owned and managed to \$21 billion. This merger produced a company with an estimated market share of 14%. They have 16 funds globally (13 in North America, one in Europe and two in Japan). These funds represent \$5.1 billion in third party equity. Since 2000, occupancy in ProLogis funds has averaged 95.1%, never falling below 93%. Over the same period, rent has grown at an average of approximately 7.9% per year with an average customer retention rate of 66%. The average co-investment by ProLogis is 22%. The returns in the North American funds since inception are as follows:

8.1% annualized unleveraged yield

9.8% annualized leveraged cash yield

14.0% unrealized unleveraged IRR

23.5% unrealized leveraged IRR

Using the six North American funds under management for more than one year as of June 30, 2005, the unrealized leveraged IRRs ranged from a low of 20.8% to a high of 31.8%. All of the U.S. funds are out of their investment period.

Recommendation

The new ProLogis North American Industrial Fund has a strong proven sponsor. There is a strong alignment of interest considering the sponsor's large co-investment and management. The investment is in a specific group of high-quality assets with asset-specific performance, rather than in a corporate entity whose performance may be impacted from activities such as 3rd-party management. It provides a means for PSERS to achieve immediate deployment of capital consistent with its strategy to increase the core allocation through open-end funds. The sponsor has an unparalleled pipeline with a solid historical track record. An investment in the fund structure should reduce the potential volatility now present in the existing public security position, while maintaining a certain degree of liquidity. The specified tiered fee structure is consistent relative to other open-end industrial funds currently in the market. Compared to the current portfolio in the REIT, the manager is required to adhere to a pre-determined list of investment and operating criteria that should produce a high quality portfolio. The REIT is currently only yielding 3.15%, while the Fund is projecting an initial cash yield of approximately 6.5% and to average 7.0% over five years. A substantial percentage of the fund consists of pre-identified high quality assets.

CONCLUSION/RECOMMENDATION

Based upon the successful track record and experience of the principals and the recommendation of PSERS' consultant, Courtland Partners, Ltd, staff recommends that the board invest an amount equal to \$200 million plus reasonable normal investment expenses, in ProLogis North American Industrial Fund, L.P., in accordance with the recommendation of Charles J. Spiller, Director of Alternative Investments, dated January 19, 2006. The final terms and conditions of the investment must be satisfactory to the Investment Office, the Office of Chief Counsel, and the Executive Director.