PSERS OPPORTUNISTIC REAL ESTATE PROGRAM

Recommendation for Investment in LEM Real Estate Mezzanine Fund II, L.P.

Charles J. Spiller
Director of Alternative Investments

April 27, 2006

LEM Real Estate Mezzanine Fund II, L.P.

EXECUTIVE SUMMARY

LEM Partners II, L.P. (the "General Partner") and its affiliates (together, "LEM"), are forming a second private equity investment fund, LEM Real Estate Mezzanine Fund II, L.P. ("Fund II" or the "Fund"). The Fund is being established to originate, purchase and manage a diversified portfolio of high-yield multifamily and commercial real estate investments which will include mezzanine loans, preferred equity, subordinated financings and other structured finance transactions ("Investments"). Fund II is a follow-on fund to LEM Real Estate Mezzanine Fund, L.P. ("Fund I"), a $150 million private equity investment fund founded in April 2002.

The day-to-day operations of LEM are led by two managing partners, Jay Eisner and Herb Miller (together, the "Managers"). In addition, Ira Lubert and Dean Adler (together with the Managers, the "Principals") provide advice and oversight with respect to Fund investments and other significant issues. Each of the Principals possesses over 20 years of professional experience investing in real estate and collectively have been responsible for managing Fund I. The Principals are supported by a team of seasoned real estate professionals who possess a broad range of transactional, financial and management skills.

The Management Team will continue to build on the success of Fund I, employing the same disciplined investment approach in Fund II which will seek to deliver exceptional risk-adjusted returns for investors. The Management Team will focus on those investments which maximize investors' current and overall return while protecting investors' downside risk. The Managers intend to manage risk by making Investments in quality projects in the United States and Canada and lending to reputable borrowers with demonstrated track records and meaningful equity commitments to their projects. The Management Team will seek to create a diversified pool of Investments which will be in moderate risk mezzanine positions, generally between 80% and 90% of the capital structure. The Fund will target an internal rate of return ("IRR") net to investors of 12% to 13%. A unique feature of this investment opportunity is the high component of current income which the Fund intends to pay to investors on a quarterly basis. The Fund will target a 9% per annum net current return to investors.

The Fund is targeted at $200 million in limited partner commitments, with a right to increase to up to $300 million. The General Partner's commitment will be 5% of all partner commitments, up to $15 million.

OVERVIEW OF THE SPONSOR

Success of Fund I - The Principals have successfully invested Fund I and established LEM as one of the premier mezzanine lenders in the United States. To date, Fund I investors have received quarterly distributions resulting in annualized cash returns on average capital through December 31, 2005 of 13.4%. Fund I has incurred no losses or write downs and the overall net return to Fund I investors is anticipated to be between 13% and 15%.

Disciplined Investment Approach - The Management Team plans to maintain the key elements successfully employed in Fund I, namely using its real estate expertise in underwriting each asset, determining stabilized cash flows, assessing the achievability of pro-forma cash flows, structuring investments appropriately to control downside risk and focusing on niche opportunities that give the Fund a competitive advantage in the marketplace.

Attractive Market Conditions – The demand for mezzanine loans is expected to rise significantly as mezzanine loans have become a readily accepted financing vehicle in the market today. With this, it is assumed that senior loan financings will be at an all time high over the next several years and many senior loan financings contain mezzanine loan components.

High Current Income – The Fund will target an IRR net to investors of 12% to 13% and the Fund will seek to structure Investments with current income which will support a 9% annual distribution to investors, paid quarterly. This high level of current income will significantly reduce the Fund's performance risk by relying on current property cash flow for a significant portion of the Fund's total return.

LEM Franchise Value – LEM has developed a reputation as a reliable lender that can evaluate the underlying real estate quickly, propose creative structures and close transactions efficiently. LEM has established itself as a leading small to medium size mezzanine lender and one of the pre-eminent mezzanine investors in the U.S. LEM intends to leverage its franchise value and strong relationships throughout the real estate industry and capital markets to source transactions that will continue to deliver appropriate risk-adjusted returns for investors.

Strong Leadership and Management – Over the past three years, Fund I had invested in 48 mezzanine and preferred equity transactions. The Principals have spent almost their entire careers in the real estate industry and have extensive experience in all aspects of real estate investment, development, ownership, management and finance. They have collectively been involved in hundreds of individual real estate transactions totaling over $10 billion and have direct and current experience in sourcing, negotiating, structuring, closing and servicing debt transactions similar to those planned for the Fund.

Proactive Asset Management – The Management Team will continue the intensive "hands-on" asset management program developed in Fund I that includes cash management mechanisms which enable the Fund to control cash upon an event of default and requires detailed monthly reporting from the borrower. Through this level of monitoring, any deterioration in property performance can be identified and corrective actions taken early.

Alignment of Partners' Interests – The General Partner's commitment will be 5% of total Commitments, up to $15 million, on the same terms as the Limited Partners.

Independence Capital Partners – LEM is a member of ICP, an affiliation of private investment funds founded by Ira Lubert, with over $6 billion in capital commitments under management. The Fund will benefit from the synergies of a substantial integrated back office providing requisite fund administration, allowing the LEM team to focus more time directly on its investments.

In addition to the infrastructure advantages, there are over 60 investment professionals throughout the various ICP Member Firms with broad experience, significant deal flow and exclusive relationships, which extend to benefit the group as a whole. This includes the sharing of ideas and expertise as well as relationships and resources. The principals of the ICP Member Firms have personally committed over $150 million to their respective funds. The following is a list of the other ICP Member Firms:

- Lubert-Adler – real estate opportunity funds
- LLR Partners – middle market buyout and growth equity funds
- Quaker BioVentures – a life science fund
- Chrysalis Capital – a middle market distressed buyout fund
- Rubenstein Properties – a real estate value added office fund
- LBC Credit Partners – a middle market corporate debt fund

MARKET OPPORTUNITY

The current U.S. real estate market is, and will continue to be, characterized by trends that create a favorable environment for real estate debt investments. These trends include: 1) improving property fundamentals driven by economic recovery, 2) a competitive environment for senior lenders, and 3) rising interest rates, which should lead to an increase in acquisition yields as well as distress for some highly leveraged owners of real estate.

The U.S. commercial real estate market is recovering from 2001-2002's demand-induced real estate recession. Initially, the impact of the downturn and tentative recovery in the U.S. economy and broader equity markets compounded with shaken investor confidence in the financial markets resulted in vacancy rate increases and rental income declines. Yet despite poor operating fundamentals, many sectors of the real estate market experienced unprecedented access to capital. Driven by low cost debt financing and perceived value versus alternative investments, capital has flowed into real estate assets, sustaining asset values and diminishing returns. Stabilized, cash flowing assets have received a disproportionate share of these capital flows, which creates opportunities for overlooked assets in transition.

While real estate asset values have benefited from both increased capital flows and low interest rates, those values may experience a "reversion to the mean" in the future, for the following reasons:

Unprecedented capital inflows. Unlike the real estate recession in the early 1990's when capital sources withdrew from the industry, many sectors of the real estate industry are enjoying unprecedented access to capital over multiple years. Normally, when fundamentals weaken and investment risk increases, such as during the last economic downturn, capital flows out of an industry.

Inflated asset values. Theoretically, when the risk associated with an investment increases, capital should become scarce, return requirements should increase and asset values should fall. In the current property market conditions, the opposite has occurred not only with the influx of capital but also in the impact on return requirements and asset values.

Declining risk premium. The influx of yield-oriented capital and lower interest rates have caused the real estate risk premium, that is, the excess return that investors require based on their perception of underlying risk, to decline. Ignoring real estate fundamentals, this decline in the risk premium is indicative of investors' willingness to increase their risk profile to achieve a given yield. When coupled with weak industry fundamentals, the declining risk premium suggests that investors either are not concerned by the increasing risk profile or, more likely, do not fully understand the risks.

Stress in real estate debt markets. Thus far, the rise in commercial mortgage delinquencies has not had a material negative impact on real estate securities markets. The variations in performance across regions and properties types as well as the diversification of credit exposure underlying real estate securities have helped to limit the performance impact. The combination of flat demand and interest rate increases could lead to significant credit impairment in the real estate securities market, creating opportunities for experienced distressed acquires such as Apollo.

Less competition for Transitional Assets. Despite the high level of liquidity in the real estate debt markets today, Apollo continues to see great inefficiency in the real estate market for “assets in transition”. This inefficiency is a permanent characteristic of the real estate markets where each asset is unique and where few lenders have the direct development and operating expertise necessary to fully understand underwrite this type of asset.

INVESTMENT STRATEGY AND PROCESS

Over the past three years, the Managers have used their real estate expertise to establish LEM as one of the pre-eminent mezzanine investors in the United States. In Fund II, the Managers will capitalize on this expertise and reputation while continuing to pursue those strategies that were successful in Fund I. Specifically, the Managers will continue to focus on maintaining a disciplined approach to investing and delivering strong risk-adjusted returns for investors.

As opposed to the real estate equity business, the real estate mezzanine business and LEM's competition, for the most part, consists of financial institutions or funds which are headed by former financial institution senior management. These organizations take a lending approach to their business by focusing on the debt structure first and the real estate second. LEM, on the other hand, has deep roots in real estate investment and approaches the business much differently. The Management Team's approach is to start with a thorough understanding of the real estate and all of the associated risks and opportunities. The Management Team completes a detailed analysis of the real estate underlying each transaction, at times coming to different value and cash flow conclusions than those of the senior lender.

It is critical to use its strong real estate expertise and extensive relationships to gather market information and underwrite transactions with the goal of 100% principal realization. In that effort, the Management Team takes full advantage of the resources of the ICP organization. By approaching the mezzanine business as a real estate business, versus a lending business, LEM can out-compete for investments when others have difficulty assessing the real estate risk. For example, certain turnaround, redevelopment or transition assets may be excellent investment opportunities if the Management Team concludes that once the borrower's stabilization plan is achieved, the mezzanine investment will be at a lower loan-to-value and higher debt service coverage ratio than it can otherwise achieve by investing in a stabilized asset. Part of the Management Team's analysis will include an evaluation of the owner's stabilization plan and determining whether the borrower has the expertise and financial strength to achieve the plan. For these situations, the Management Team will use its real estate expertise to determine whether the risk associated with the investment is warranted given its return expectations. This real estate based approach allows the Management Team to effectively compete for these loans since they require extensive underwriting and structuring.

Another important strategy for LEM is pursuing preferred equity investments. Many properties in the market today are encumbered by long-term fixed-rate first mortgage debt. These mortgages contain yield maintenance penalties making the cost to prepay the loans excessive. Many times the buyers of assets are required to assume these existing first mortgages which are often less than 75% of the purchase price. Often, the buyer needs subordinate financing, in the form of preferred equity, to bridge the gap between the existing first mortgage and the equity and still comply with restrictions that the senior lenders impose on mezzanine financing. These transactions can often be complex and time consuming. The Management Team excels at these opportunities and structures transactions which often result in exceptional risk adjusted returns. Given the underlying first mortgage's low loan-to-value, the investment is often priced comparable to high leverage mezzanine financing; however, in reality, a large component of this investment is in the first mortgage traunche of the capital structure. LEM has established itself as a prominent player in preferred equity financing and has gained recognition among the CMBS servicers as a leading provider of this product. Fund I invested in 23 preferred equity transactions totaling $75.5 million and this successful strategy will be continued for Fund II.

LEM has developed significant franchise value and has established itself as one of the preeminent mezzanine lenders in the marketplace. In Fund I, the Management Team invested in 48 transactions involving 127 properties. To accomplish this, the Management Team evaluated hundreds of transactions and spent a significant part of its time developing deep-rooted relationships with mezzanine borrowers, capital markets players and mortgage brokers, all of whom provide a continual source of transactions for LEM's pipeline. The Management Team has developed strategic alliances with key investment banks which have become a significant source of new transactions. Given the liquidity in the marketplace, these institutions have gained confidence in their ability to principal and then subsequently sell the mezzanine components of the capital structure, making it more important to develop relationships with the investment banking community. Over the past three years, the Management Team has sourced transactions with 11 different investment banks. The Management Team has developed strong relationships with many of the major investment banks who often partner with LEM to offer borrowers combined senior and mezzanine loans. At times, these lenders will close both the senior and mezzanine loans and then offer the mezzanine loan to the Fund. Over time, these relationships have played a larger role in transaction sourcing as more borrowers desire a one-stop solution for their financings.

In addition to multiple transactions with investment banks, 55% of Fund I's transactions in 2005 were from repeat borrowers. One key reason is that LEM services all of its loans in-house. In-house loan servicing allows the Management Team to control the quality of loan servicing and responsiveness to borrowers. The Management Team's ability to respond to borrowers' needs is one of the major reasons it has built these strong relationships. This repeat business has been one of the key reasons LEM has increased its volume each year and will be a key to the success of Fund II.

Another important relationship for LEM is with the affiliated ICP Member Firms, particularly Lubert-Adler. Lubert-Adler has over 50 operating partners nationwide ("Operating Partners") that provide a source of transactions for the Lubert-Adler Real Estate Funds. Fund I has entered into five transactions with Operating Partners. These investments were inappropriate for the Lubert-Adler Real Estate Funds but were solid mezzanine investments. The Operating Partners are not only a source of investments for LEM, but they provide an extensive depth of knowledge in the markets in which they operate. The Operating Partner network assists the Management Team in both underwriting and market intelligence and allows the Management Team to respond reliably and quickly to requests from the market. The Operating Partner network provides the Management Team with resources not available to our competition and results in a reliable and quick response to the party requesting the mezzanine loan. LEM has developed an excellent reputation in the marketplace for responding quickly and a key reason is the Operating Partner network.

Fund I invested in two transactions in Canada and their performance has been excellent. In addition, the investment structures for these Canadian transactions have been more conservative and have resulted in excellent risk adjusted returns. The Management Team has spent a significant amount of time in Toronto and Montreal building relationships and developing a program for Canada. For the investments in Canada, Fund II will reduce or eliminate foreign exchange risk through various currency hedging techniques The Fund will restrict investments outside of North America to 10% of commitments.

Recently, Collateralized Debt Obligations or CDO's have become a well-developed mechanism for the financing of mezzanine and preferred equity investments at very attractive loan spreads. The CDO involves an accumulation of transactions and subsequent securitization and sale into the capital markets. The CDO can act as an effective financing vehicle for mezzanine funds. Historically, financing for these mezzanine investments has involved a line of credit from banks which are more expensive. The Fund may take advantage of these CDO or similar types of financing options as a way to finance its investments on a cost effective basis.

MANAGEMENT OF THE FUND

Jay J. Eisner. Mr. Eisner is a principal and co-founder of LEM, and along with Mr. Miller, will lead day-to-day management of the Fund. He has spent most of his 26-year career in the real estate industry. From March 1997 until April 2000 he was President and Chief

Operating Officer of RAIT Investment Trust (NYSE: RAS). RAS is a publicly traded commercial mortgage REIT specializing in the origination of high-yield real estate loans substantially similar to those targeted for the Fund. At RAS, Mr. Eisner developed and implemented a program of providing subordinated financing and other structured financings to the real estate sector. From 1994 to 1997, Mr. Eisner was the Chief Financial Officer of Washington Capital Corporation, a private investment firm providing non-conforming commercial mortgage financing to real estate developers and others. At Washington Capital Corporation, he was responsible for sourcing, underwriting, structuring and closing transactions involving over $100 million of real estate investments and mortgage loans, many of which were similar to those planned for the Fund. From 1983 to 1994, Mr. Eisner was the Chief Financial Officer for two related real estate investment and development companies, where he was responsible for arranging all financing including first and second mortgage loans, investor note financing, construction loans, bridge financings and lines of credit. From 1979 to 1983, Mr. Eisner was a Supervisor with Touche Ross & Company, predecessor to Deloitte and Touche, certified public accountants. Mr. Eisner holds a bachelors degree from Rutgers College.

Herbert L. Miller, Jr. Mr. Miller is a principal and co-founder of LEM and, along with Mr. Eisner, will lead the day-to-day management of the Fund. He has over 20 years of real estate investment experience. Prior to LEM, Mr. Miller was a principal of Lubert-Adler Real Estate Funds, sourcing transactions and investing capital in real estate transactions. Prior to Lubert-Adler, Mr. Miller was a principal of Lend Lease Real Estate Investments, Inc., based in New York. In that role, Mr. Miller was head of Lend Lease's Capital Advisory Group, responsible for all financing activities of Lend Lease-managed clients as well as for originating and executing finance advisory assignments for non-managed clients. Mr. Miller also created Lend Lease's mezzanine fund, raising $60 million of sponsor seed capital. Mr. Miller structured and closed over $4.5 billion in financing transactions, including whole loans, construction loans, CMBS, mezzanine loans and lines of credit. Prior to joining Lend Lease, Mr. Miller was a member of the Loan Restructuring Group at Citibank, was an Associate with Banker's Trust and was a Senior Audit Manager with Peat Marwick. Mr. Miller received a B.S. degree in Accounting from Boston College and an M.B.A. degree in Real Estate Finance from Columbia Business School.

Ira M. Lubert. Mr. Lubert is principal and co-founder of the LEM, as well as Lubert-Adler Real Estate Funds (I-V), Rubenstein Properties, LLR Partners, Quaker BioVentures, LBC Credit Partners and Chrysalis Capital that together constitute the Member Firms of Independence Capital Partners. Mr. Lubert has 28 years of experience in the real estate investment sector. Prior to forming Lubert-Adler, Mr. Lubert was a principal and founder of TL Ventures within the family of Safeguard Scientifics, Inc. (NYSE: SFE), an early-stage venture fund. Mr. Lubert was also a founder of Radnor Venture Partners, L.P., the first venture fund managed by Safeguard Scientifics. Mr. Lubert holds a B.S. in human development from Pennsylvania State University and currently serves on the board of directors for Eureka-GGN, Jefferson Hospital, The Franklin Institute, PREIT, and the Wistar Institute. Mr. Lubert also serves or has served on various community boards. He served three years on the Board of Trustees of Pennsylvania State University, is a past chairman of the United Way Campaign of Philadelphia and is an active recruiter for the Alexis de Tocqueville Society of the United Way.

Dean S. Adler. Mr. Adler is the principal and co-founder of Lubert-Adler Real Estate Funds (I-V). Mr. Adler has 20 years of experience in the real estate investment sector. Prior to forming Lubert-Adler, Mr. Adler was a principal and co-head of acquisitions for the private equity group of CMS Companies. During his 12 years at CMS, Mr. Adler specialized in acquiring real estate and operating businesses within the private equity markets. Mr. Adler was also previously associated with the accounting firm of Ernst & Whinney and the law firm of Baker & Hostetler. Mr. Adler holds a B.S. from the Wharton School and a J.D. degree from the University of Pennsylvania Law School. Mr. Adler was also an instructor at the Wharton School of the University of Pennsylvania between 1981 and 1983 and received recognition for teaching excellence in 1982. Mr. Adler currently serves on the board of directors of Bed Bath & Beyond and Electronics Boutique (both NASDAQ-listed companies) as well as Developers Diversified Realty Corporation, a NYSE-listed REIT. Mr. Adler serves on numerous community boards, including the UJA National Young Leadership Cabinet, and he is a member of the Alexis de Tocqueville Society of the United Way. In addition, Mr. Adler is a member of the Philadelphia Mayor's Planning Committee and was a participant in the city's Economic Development Summit in June 2004. Mr. Adler is also involved with various philanthropic causes both locally and nationally.

Dr. Peter Linneman. Dr. Linneman is recognized as the leading scholar and advisor in real estate, finance and economics, writing extensively on the evolution of the industry, the future of office demand, residential affordability and institutional investment in real estate and real estate capital markets. Dr. Linneman was the director of the Wharton Real Estate Center at the University of Pennsylvania from 1985 – 1998 and has been a member of Wharton's faculty since 1979. He is the former chairman of Rockefeller Center Properties, Inc., and serves on the boards of a variety of public and private companies. Dr. Linneman received his M.A. and Ph.D. in economics from the University of Chicago.

Brian J. Morris. Mr. Morris is a Managing Director for LEM responsible for sourcing, underwriting and closing investments for the Fund. He has over eight years of real estate experience and has been involved in over $500 million of senior and mezzanine loans across various asset classes. Prior to LEM, Mr. Morris was a Director in GE Real Estate's Strategic Capital Group where he was responsible for originating large and middle-market floating and fixed-rate loans. He was also a Vice President in Wells Fargo's Real Estate Merchant Banking Group, originating, negotiating and closing whole loans, mezzanine loans and lines of credit. Prior to joining Wells Fargo, Mr. Morris was a Founder and Chief Information Officer for CapitalEngine.com, an online real estate investment bank, where he was integral in raising over $8 million in venture capital and was also responsible for establishing lender relationships, developing underwriting and loan packaging models, and marketing. Mr. Morris started his real estate career with Bear Stearns as an Associate in its Commercial Mortgage Group. Prior to real estate, he was a fixed-income Trader with SBC Warburg, a fixed-income Trader with Fannie Mae, and an Industrial Engineer with the Naval Research Laboratory. Mr. Morris received a B.S. degree in Industrial Engineering from Rensselaer Polytechnic Institute and an M.B.A. degree in Finance from Georgetown University.

Eric Emrich. Mr. Emrich serves as CFO, Vice President and Treasurer of each ICP-affiliated fund manager, and has 20 years of real estate experience. He is responsible for all finance, accounting, tax, information systems, human resources and risk management for Lubert-Adler. Prior to Lubert-Adler, Mr. Emrich was Tax Director and Controller for all of the CMS Companies' funds. He was also a Managing Partner for an SEC registered investment advisor in Plymouth Meeting, PA. In addition, Mr. Emrich spent 12 years in public accounting, the last seven years of which was with KPMG, LLP in Philadelphia as a Senior Tax Manager. He is a Certified Public Accountant and a Certified Management

Accountant. Mr. Emrich is a member of the American and Pennsylvania Institute of CPAs, the Delaware Society of CPAs, the Greater Philadelphia Venture Group, the Philadelphia Estate Planning Council and the Institute of Management Accountants. He currently serves on the Board of the Philadelphia Chapter of the Private Equity CFO Association and spent five years as an Adjunct Professor in the Drexel University Master of Taxation Program. Mr. Emrich graduated cum laude from the University of Delaware with a B.S. in Accounting with Economics as a second major. He also received his M.S. in Taxation from Widener University.

F. Carter Hughes II. Mr. Hughes is a Vice President of LEM with over five years of real estate experience. His primary responsibilities include sourcing, underwriting, performing due diligence, closing, and monitoring investments for the Fund. Prior to LEM, Mr. Hughes was an Associate for Chatsworth Securities in their Real Estate Investment Banking Group, where he focused on raising equity for developers through institutional partners and syndications. Prior to joining Chatsworth, Mr. Hughes was the Co-founder and Chief Operating Officer of Our City Sports, LLC where he was an integral part of sourcing $1 million of venture capital for the start-up company. Mr. Hughes received a B.E. degree in Mechanical Engineering from Vanderbilt University and an M.S. degree in Mechanical Engineering and an M.B.A. from the University of New Mexico.

J. Bradley Murphy. Mr. Murphy is the Head of Asset Management for LEM with over three years experience in the real estate investment sector. His primary responsibilities include monitoring investments for the Fund, underwriting, performing due diligence, closing, and strengthening and maintaining relationships with existing borrowers, asset managers and property managers. Prior to joining LEM, Mr. Murphy was an Associate in acquisitions and asset management with Lubert-Adler. Mr. Murphy received a B.S. degree in Finance from St. Joseph's University.

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 25% of the committed capital, but not to exceed $75 million plus reasonable normal investment expenses, in LEM Real Estate Mezzanine Fund II, L.P.. The final terms and conditions of the investment must be satisfactory to the Investment Office, the Office of Chief Counsel, and the Executive Director.