COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

DATE: September 27, 2007

SUBJECT: Centerline Real Estate Special Situations Mortgage Fund, L.L.C.
Commitment increase

TO: PSERS' Finance Committee/Board

FROM: Charles J. Spiller CJS
Director of Private Markets and Real Estate

Based on the market information provided by Centerline, an unprecedented buying opportunity for the Fund has developed. It is staff's and Courtland's recommendation to increase the approved commitment to the Centerline Real Estate Special Situations Mortgage Fund from $89.25 million to $178.50 million. (The Fund was originally approved as ARCap Real Estate Special Situations Mortgage Fund.)

Centerline Real Estate Special Situations Mortgage Fund, LLC ("CRESS" or the "Fund") commenced operations in May 2006. CRESS was formed for the purpose of investing in high-yield commercial real estate debt products, including bridge loans, B-notes and mezzanine loans. As of June 30, 2007, CRESS held an interest in 32 outstanding bridge loans, B-notes and mezzanine loans with a carrying value of $327.8 million and a weighted average unleveraged yield of 8.91%. Additionally, CRESS holds a portion of six classes of floating rate securities plus a portion of the preferred equity of a collateralized debt obligation offering. These CRE-CDO investments have a total purchase price of $91.6 million and a weighted average unleveraged yield of 11.61%. As of June 30, 2007, CRESS was generating levered returns to investors, net of management fees, of 12.1%. CRESS has suffered no losses and all of its investments are current as of June 30, 2007. These figures have not changed appreciably since June 30, 2007.

As of this writing, the real estate capital markets are in a state of disruption. The CRE-CDO market is almost completely inactive and the CMBS market is trading very lightly at historically high yields. That illiquidity in the capital markets has made it very difficult for the commercial mortgage origination companies to determine the correct pricing and credit characteristics for commercial mortgages, which has caused them to markedly slow new loan origination. Firms with business plans which were predicated on the rapid securitization of commercial mortgages through the CMBS and CDO markets have been caught with significant inventories of mortgages held for sale. Those firms are under pressure to liquidate those mortgages because accounting principles require the firms to carry the mortgages at current market value, which requires them to reduce their value in a market with higher required yield requirements and more stringent credit standards. Furthermore, creditworthy real estate borrowers are having difficulty obtaining appropriate financing as the commercial mortgage origination firms stand by the sidelines waiting for the capital markets to stabilize.

The real estate capital markets are experiencing a rational reassessment of the economic underpinnings of real estate securitization and of the risk/return proposition it represents. In Centerline's view, the CMBS and CRE-CDO markets will ultimately stabilize intact because they are fundamentally sound and meet a legitimate market demand. Centerline believes that by selectively acquiring B-notes, Bridge Loans and Mezzanine Loans that are currently available to the Company, unlevered returns in excess of 10% and levered returns in excess of 15% can be attained with respect to new acquisitions. The Company currently has $200,000,000 in repurchase facilities in place with affiliates of Bear Stearns and $150,000,000 with Morgan Stanley Bank, which have terms until May 2008 and June 2009 respectively, so that short term financing liquidity is available to the Company. In addition, the Company also has a revolving subscription line in place with JPMorgan Chase Bank in an amount up to $125,000,000 that expires in April 2010. Centerline has not received any indication that these financing arrangements will not continue to be available. The Company is not under any pressure to obtain permanent financing through a CRE-CDO at this time, so that the current lack of liquidity in that market should not adversely affect the Company's ability to generate the levered returns noted above.