ACTION SUMMARY

INVESTMENT COMMITTEE

March 26, 2015

MINUTES OF THE

NEW MEXICO EDUCATIONAL RETIREMENT BOARD

INVESTMENT COMMITTEE

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1. a. **Call to Order**

A meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at 12:00 p.m. in the Educational Retirement Board Conference Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico.

Members Present:
Mr. H. Russell Goff, Chair
Ms. Mary Lou Cameron [by telephone]
Mr. Larry Magid
Dr. Beulah Woodfin

Members Excused:
None.

Staff Present:
Ms. Jan Goodwin, Executive Director
Mr. Bob Jacksha, CIO
Mr. Steve Neel, Deputy CIO
Mr. Mark Canavan, Real Assets Portfolio Manager
Mr. Aaron Armstrong, Portfolio Manager

Others Present:
Mr. Carl Boaz, Recorder
Mr. Kevin Tatlow Top Tier Capital Partners
Mr. Steve Gruber, RAPM
Mr. Brent Burnett, RAPM
Mr. Dan LeBeau, NEPC

b. **Approval of Agenda**

Item 7 (Q4 Infrastructure Performance Report) was deferred to the April meeting.

Dr. Woodfin moved approval of the agenda, as amended. Mr. Magid seconded the motion, which passed unanimously by voice vote.

c. **<u>Approval of Minutes of 2/26/15</u>**

Dr. Woodfin moved approval of the minutes of the February 26, 2015 meeting, as submitted. Mr. Magid seconded the motion, which passed unanimously by voice vote.

d. **<u>Introduction of Guests</u>**

Mr. Neel introduced Aaron Armstrong, who has joined Investment staff and will be working with him and Mark Canavan.

2. **<u>TPG GROWTH III, L.P.</u>**

[Steve Neel and Kevin Tatlow.]

Mr. Neel presented staff's recommendation of a $100 million commitment to TPG Growth III.

Mr. Neel noted that the ERB also has a commitment in Fund II, which was made in 2012. At the time of that investment, the ERB did not have much exposure in growth-oriented strategies and, in response, made a commitment to TPG Growth II as well as Warburg Pincus for $75 million, Audax Group for $40 million, and Edison Ventures for $30 million. Together, these commitments totaled over $200 million, and to date they have a net IRR in excess of 20 percent, with TPG Growth at a net 40 percent.

Mr. Neel said TPG is a household name in private equity and goes back over two decades. TPG has over 300 investment professionals globally, and there are 44 investment professionals dedicated to the growth strategy. The platform spans a number of different private equity strategies, from venture to buyout to distressed.

Mr. Neel noted that TPG 's buyout investment in TXU Energy of a few years ago, and which has been the subject of news reports more recently, is not reflective of the strategy under discussion today.

Mr. Neel said TPG Growth focuses on healthcare, industrials, business services, retail and consumer, media and technology.

Mr. Neel said TPG disclosed no campaign contributions, and uses TPG Capital BB, its internal placement agent that focuses only on TPG funds.

Mr. Tatlow presented Top Tier's report on TPG Growth III.

-- TPG Growth is raising $3 billion for TPG Growth III, TPG's third fund targeting middle market growth equity and buyout investments with select opportunistic investments in venture capital. The fund will follow the same flexible strategy as the two predecessor funds. While the fund is 50 percent larger than the predecessor fund, which raised $2 billion, it is not targeting larger investments, but the larger size reflects the investment capacity of a growing investment team.

-- The fund is targeting a net return of 20 percent and a 2.5x from a portfolio that will target small and middle-market buyout and growth equity opportunities requiring $50 million to $100 million of equity.

-- The fund expects to invest primarily in North America, as well as in China and India, and selectively across other developing markets, including Africa and Southeast Asia.

Responding to Ms. Goodwin, Mr. Tatlow said TPG does not rely on shared resources, as they have their own dedicated operational group of nine senior people who reside within their team. The firm will, however, assign someone from another area of the firm to a deal if there is someone in their firm who has great experience and can help out with diligence, etc.

Ms. Goodwin noted Mr. Tatlow's comments that there have been five partner/managing director departures since the inception of the strategy with the majority of the transitions in Asia, and that they have assembled a team that promises to have a lower level of turnover. She asked how TPG will be able to ensure that is the case.

Mr. Tatlow responded that there has been some turnover in Asia and some upgrading of the team. One of the professionals associated with Asia did not want to relocate back to India, for example. He commented that it is challenging to find top talent in Asia because there has been a land rush by private equity sponsors to get their hands on the best talent, particularly in India and China. He said Top Tier does not expect the same level of turnover going forward.

TPG Growth representatives Bill McGlashan and Charles Froeb appeared before the Committee and made a presentation.

[Representatives left the meeting following the presentation.]

Mr. Jacksha noted that this would be the largest investment, at $100 million, that the ERB will have made in private equity, excluding the BlackRock separate accounts. He said staff thinks very highly of TPG, and he would urge the committee to approve this.

Dr. Woodfin moved that the Investment Committee approve a commitment of $100 million to TPG Growth III, L.P. The commitment is subject to New Mexico State Law, Educational Retirement Board policies, Educational Retirement Board approval for placement agents, and negotiation of final terms and conditions and completion of appropriate paperwork. In addition, staff will be granted discretion to invest an additional amount, not to exceed $10 million, in secondary partnership interests offered by the other limited partners in the fund, should they become available from time to time, under the Right of First Refusal provisions of the limited partnership agreement for this fund. Mr. Magid seconded the motion, which passed unanimously by voice vote.

3. SARES REGIS FUND II

[Presenters: Mark Canavan and Steve Gruber.]

Mr. Canavan presented staff's recommendation of a $30 million commitment in Sares Regis Multifamily Value-Add Fund II, noting that the ERB invested in Sares Regis Multifamily Fund I in 2013. Fund II's target fund size is $250 million. No placement agent or campaign contributions related to New Mexico have been disclosed.

Mr. Canavan presented an overview of his investment thesis. He said staff believes the current economic and market environment provides an exceptional opportunity for continued real estate equity investment with a partner having a strong established record.

Mr. Gruber said Sares-Regis has a strategy in high rent-to-own differential markets on the West Coast. The ability for the younger generation to buy a house in these markets is challenging, so they seek to rent. When a group like Sares-Regis comes in and renovates anapartment complex, rents of $1,500 a month can go to as high as $2,100 a month, so the return on invested capital is very high and offsets the highly competitive nature in buying these assets.

Mr. Gruber said Sares-Regis bought nine properties in Fund I, with a projected net return of 14-15 percent and a 1.7x. Once these properties are stabilized, they will hold them for a longer period of time, which builds the multiple up in terms of return, and they are generating an 8 percent cash-on-cash return during the holding period. There have been no significant changes in the organization since 2013, with the exception of the addition of a construction manager.

Mr. Gruber said a second real estate investment being recommended on today's agenda is in RAM Realty IV, a Southeast multifamily strategy, where job growth and population growth is above the national average. RAPM likes this strategy along with that of Sares-Regis, because it offers a two-pronged approach with regional people that RAPM feels will outperform a group operating over all geographies.

Sares Regis Group representatives Geoffrey Stack, Robert Wagner, William Montgomery and Ken Gladstein appeared before the committee and made a presentation.

Mr. Jacksha noted that return expectations in Fund II are lower than in Fund I. He asked if this is because Sares-Regis has to pay higher acquisition prices or higher rehab costs or is the financing at a higher cost. Mr. Stack responded that it is a combination of all three. Pricing has moved up in all assets. Sares-Regis has also lowered its rent growth assumptions, and while financing costs have stayed relatively stable, compression has become an issue because of the amount of capital coming into multifamily housing.

[Representatives left the meeting.]

Mr. Jacksha stated that this is a manager that ERB has invested with, they did what they said they would do in the portfolio, there have been no major changes, and the ERB would certainly like to keep them as a partner.

Dr. Woodfin moved that the Investment Committee approve a commitment of $30 million to Sares-Regis Fund II. The commitment is subject to New Mexico State Law, Educational Retirement Board policies, Educational Retirement Board approval for placement agents, and negotiation of final terms and conditions and completion of appropriate paperwork. In addition, staff will be granted discretion to invest an additional amount, not to exceed $10 million, in secondary

partnership interests offered by other limited partners in the fund, should they become available from time to time, under the Right of First Refusal provisions of the limited partnership agreement for this fund. Mr. Magid seconded the motion, which passed unanimously by voice vote.

[Ten-minute break.]

4. ENERVEST ENERGY XIV

[Presenters: Mark Canavan and Brent Burnett, RAPM.]

Mr. Canavan presented staff's recommendation of a $37.50 million investment in Enervest Energy Institutional Fund XIV.

-- The Fund is a $2.5 billion energy investment fund that will acquire, develop, operate and strategically divest of upstream oil and gas properties, primarily located in the Continental U.S.

-- The fund will target net returns of 16-18 percent through a combination of conservative leverage, improved operating efficiencies, and increasing reserve volumes through enhanced drilling programs.

-- The fund will acquire upstream assets with transaction values ranging from $100-$500 million where 30-50 percent of the value lies in current production, with the remaining value attributed to upside development opportunities.

Mr. Canavan stated that, while no placement agent was disclosed, there was a $5,200 campaign contribution to Susana Martinez and a $10,000 contribution to Advance New Mexico Now, a PAC.

Mr. Canavan stated that natural gas and petroleum prices have declined. The leverage on a lot of production assets and exploration production assets, and the loans that these portfolio companies have historically with competitors, are based on the actual value of the underlying cash flow stream of the oil or natural gas reserve. Depending on the value of the oil field, leverage ratios will go down twice a year; and because of the decline in prices, the value of these assets will drop in the spring with a much larger drop in the fall, as calculations are done on a rolling average. He said people will start selling off their portfolios in the fall to gain capital to pay off their leverage, making this a good time to invest. He noted that EnerVest already has a low leverage ratio of 45 percent and a very long history of doing acquisition of these production assets. He said the acquisition environment is expected to be very good over the next two to three years.

Dr. Woodfin asked if this is really a "distressed properties" fund. Mr. Canavan responded that opportunities will arise due to other people's distress, but they are not a distressed player per se.

Mr. Jacksha said they are not trying to buy distressed properties, but they may buy properties from people who have a distressed balance sheet because they essentially bought and developed the asset at the wrong time.

Mr. Burnett added that he would invest in this group in any commodity price environment because they are very good operators of these commodity properties. On top of that, the baseline return one would expect from them in any commodity-pricing environment is going to be based on some distress selling over the time period they will be buying assets, and there will be a valuation bump in the expected return as a result.

Mr. Burnett commented that EnerVest is a unique structure in the sense that they are structured as an operating company and use a private fund vehicle to fund their operations, but it is very comparable with an oil and gas company that trades on a public exchange. They buy the assets, operate them, optimize them for sale, and sell them. He commented that the gross to net spread to ERB is going to be much narrower than in a typical energy private equity fund where the investor is paying for multiple levels of promote to different groups. In this case, there is only a single layer of fees that gets passed through.

Ms. Goodwin asked why the ERB hasn't seen this group before, and Mr. Burnett responded that EnerVest had just closed the fund before this one shortly before the ERB changed its investment policy to include energy investments.

Mr. Magid noted that EnerVest has one publicly traded entity attached to them, which is EV Partners MLP, which is down 80 percent and they have cut their distribution 65 percent, which may not even be enough. He asked what the connection is financially between the two other than EnerVest being the general partner.

Mr. Burnett responded EnerVest has been a longtime private operator. In 2006-07, EnerVest recognized the disconnect between the development type assets they pursued within the private fund structure and the highly producing assets that are more suited for an MLP structure. They created MLPs to be able to drop down these assets from the fund vehicle into the MLP. Essentially, they are trying to convert a non-producing asset into a producing asset, and the cost of capital between the two is very high. If they can sell that into a lower cost of capital vehicle, they can earn a very significant spread, and that is the objective of the upstream MLP.

Mr. Magid noted that EnerVest just had a shift in top management, and asked if that will have an effect.

Mr. Burnett responded that Mark Houser recently resigned as COO of EnerVest and President of EVEP to take the top position with the Texas Land Board. He was also on the EnerVest investment committee and had been at EnerVest for 25 years. Mr. Burnett said Mr. Houser remains an adviser to EnerVest and left on very good terms. His shares will be distributed back to the company over time so they can be shared with the younger professionals in the firm. The departure was significant, but was planned, and Mr. Houser had more of an operating role on the MLP and not on the fund's business.

Mr. Magid asked if Mr. Houser's departure would hurt EnerVest's borrowing relationships, and Mr. Burnett responded that he did not believe so, based on comments during the due diligence process from some of the largest banks in the oil and gas sector who have had relationships with EnerVest.

Jim Vanderhider, Executive Vice President and CFO of EnerVest, appeared before the committee and made a presentation.

Mr. Magid commented that he was in Dallas in 1986 when all the banks went out of business. He asked what EnerVest's lending relationships are with banks now, and wondered if this is going to be a repeat.

Mr. Vanderhider said the banks worked with producers during the 2008-09 financial crisis, although this time around it is a bit different. Now there has been a major downturn in the markets along with excessive leverage, and energy is the asset class that's traded down. He said domestic equities are at an all-time high, and the situation in Europe seems to be improving, so banks may take a different position surrounding energy producers. He said EnerVest uses the first lien secured borrowing base for non-investment grade companies. He said EnerVest is one of the top clients with Wells Fargo, and when they do their spring borrowing base review, roughly one quarter of the producers in that first line secured borrowing base will have some level of deficiency and will have to go to the banks to work out the deficiency. He said EnerVest works with the head people at Wells Fargo, and while there will likely be a lot more asset turnover during that time, EnerVest is very well positioned because it does not use a lot of leverage. While it has a limit of 45 percent, EnerVest typically does not go above 35-40 percent.

With respect to leverage, Ms. Goodwin noted that the presentation materials state that Fund XIV plans to raise $2.5 billion with a $3 billon hard cap, and $4.2 billion to $5 billion with leverage. Mr. Vanderhider responded that this is the equity component. He said they have two structures, one primarily for taxables and the other for tax-exempts, with their own capitalization, but they have the benefits of leverage. The leverage itself (debt to total capitalization) is capped at 45 percent, but the numbers reflected in the $4.2-$5 billion should represent a 40 percent gross up of debt being part of the capitalization. He said the equity component of the capitalization is 60 percent and the leverage component is 40 percent.

[Mr. Vanderhider left the meeting.]

Mr. Jacksha said this is a good time to enter the market, and RAPM is looking at some other potential investments in this area. He said clearly the team has significant expertise, and the structure also makes sense.

Dr. Woodfin moved that the Investment Committee approve a commitment of $37.50 million to EnerVest Energy XIV. The commitment is subject to New Mexico State Law, Educational Retirement Board policies, Educational Retirement Board approval for placement agents, and negotiation of final terms and conditions and completion of appropriate paperwork. In addition, staff will be granted discretion to invest an additional amount, not to exceed $10 million, in secondary partnership interests offered by other limited partners in the fund, should they become available from time to time, under the Right of First Refusal provisions of the limited partnership agreement for this fund. Mr. Magid seconded the motion, which passed unanimously by voice vote.

5. **RAM REALTY IV**

[Presenters: Mark Canavan and Steve Gruber, RAPM]

Mr. Canavan presented staff's recommendation of a $40 million investment in Ram Real Estate Fund IV, L.P.

-- RAM completed the required disclosures. No placement agents or campaign contributions were noted.

-- RAM is a value-add real estate fund in the Southeast focusing on multifamily housing and retail. The firm has a family history in real estate dating back four generations to 1921 and is dedicated to the investment and management of commercial, retail and multifamily real estate.

-- In June 2012, the ERB made a $30 million investment in RAM III. RAM management has been consistent in delivering the performance and geographic diversification originally anticipated in the fund's documents. At December 2014 year end, Fund III current projected net returns are 13.8 percent net of fees, with a 1.2x multiple on invested capital. Over the life of the fund, RAPM projects the fund will deliver a 14.3 percent return with a 1.6x multiple.

-- The ERB has had a seat on the limited partnership advisory committee since its investment in RAM Fund III.

-- The company invests in the broader geographic area of the Southeast including Charlotte and Raleigh, N.C.

Mr. Gruber said there has been one change in the company since the last investment. Founder Peter Cummings and his son Casey have been working together since 1991. In 2015, Peter Cummings announced that he will retire from his duties at RAM to focus on family business and philanthropic initiatives, but will serve as a strategic adviser to the fund. Mr. Gruber said this is not expected to change the day-to-day operations of the fund at all. Mr. Gruber also noted that the family will continue to invest in the fund as before.

RAM representative Casey Cummings appeared before the committee and made a presentation.

[Mr. Cummings left the meeting.]

Mr. Jacksha noted that this is a follow-on investment, and the manager did what the ERB expected them to do. There are good underpinnings for the region they are in, and he would recommend approval.

Dr. Woodfin moved that the Investment Committee approve a commitment of $40 million to Ram Realty IV. The commitment is subject to New Mexico State Law, Educational Retirement Board policies, Educational Retirement Board approval for placement agents, and negotiation of final terms and conditions and completion of appropriate paperwork. In addition, staff will be granted discretion to invest an additional amount, not to exceed $10 million, in secondary

partnership interests offered by other limited partners in the fund, should they become available from time to time, under the Right of First Refusal provisions of the limited partnership agreement for this fund. Mr. Magid seconded the motion, which passed unanimously by voice vote.

6. PRIVATE EQUITY PACING PLAN

[Presenters: Steve Neel and Kevin Tatlow, Top Tier.]

Mr. Neel and Mr. Tatlow presented a summary of the ERB's private equity pacing plan.

-- Pacing: ERB can continue to grow its allocation toward target by committing approximately $325 million per year for 2015-2016.

- Top Tier recommends working from a two-year pacing plan, as many existing funds returning to market are coming at the end of 2015 or early 2016.
- Pacing model should be revised annually or following significant changes in market conditions.
- This model assumes all commitments planned in the prior pacing plan are implemented.

-- Strategy selection: ERB should continue to invest in growth, buyout, distressed, secondaries and energy while working to emphasize the following portfolio actions over the next two years:

- Europe – currently hold a very low weighting in Europe, recommend evaluating current and new GPs specializing in the region.
- Venture capital – currently very low weighting to the asset class, recommend evaluation of potential primary fund strategies in the space to slowly build an allocation.
- Distressed and opportunistic – evaluate options to make opportunistic commitments if significant distressed opportunities occur.
- Lean toward growth over buyouts and emphasize managers that are smaller or value oriented.

Dr. Woodfin asked if the recommended focus on Europe, given its current state of flux, is being opportunistic.

Mr. Tatlow responded that the hope is that the economic growth situation in Europe will bottom out and begin to improve and start catching up to the U.S. He said and the plan is to take time to look at opportunities there.

Mr. Jacksha added that Europe is entering quantitative easing right now, and if it has the same effect there as it did in the U.S., it will tend to inflate asset prices.

Mr. Neel noted that investment staff is currently looking at a lot of investment opportunities in Europe.

7. PENSION RISK TRANSFER

[Presenters: Dan LeBeau and Lynda Dennen (by telephone), NEPC]

Mr. LeBeau said this analysis was done in response to a question about what it would potentially cost to annuitize the liability of the current retirees in the plan. He stressed that a lot of assumptions went into the analysis and the numbers used were on the conservative side.

Ms. Dennen discussed the assumptions she used, and presented the analysis summary.

-- The fund does not currently have enough assets to purchase annuities for all retirees. If the ERB purchased annuities for everyone in the plan, it would be left with $8 billion in liabilities and no assets, so the plan would be 0 percent funded.

-- The plan was 66.9 percent funded as of July 1, 2014 on a Market Value basis.

-- If the committee wanted to purchase annuities for all retirees, an insurance company would value the retiree liability using a market discount rate (closer to 4-5 percent) and using revised mortality assumptions. 5 percent is a ballpark estimate of moving to the RP-2014 mortality table. A more accurate estimate of the cost of mortality improvements will be calculated by GRS in the next few months.

-- In addition, insurance companies charge a premium for their service and risk. Current estimate of this premium is 4 percent per the Mercer Pension Buyout Index.

Ms. Goodwin commented that what is driving corporate America to do this is that, with corporate pension plans, there is no employee contribution. For the ERB, the employees contribute 40 percent to the plan. In addition, corporate America is doing this because they want to focus on their core business. The ERB's core business is providing pensions. She said that, when corporations remove these liabilities from their balance sheet, they no longer have to pay as much in premiums to the Pension Benefit Guarantee Corporation, so they are strongly motivated.

Ms. Dennen said Ms. Goodwin was entirely correct. She added that sometimes a pension plan can take down an entire company.

8. OTHER INVESTMENT REPORTS AND DISCUSSIONS

Mr. Jacksha said preliminary numbers for the February report are at 1.8 percent.

9. NEXT MEETING: THURSDAY, APRIL 23, 2015

The committee agreed to schedule the meeting at 1:00 p.m.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at 4:55 p.m.

Accepted by:

H. Russell Goff

H. Russell Goff, Chairman