

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
ALTERNATIVE INVESTMENTS COMMITTEE

June 11, 2008

CALL TO ORDER

A Regular Meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at approximately 1:15 p.m. in the Educational Retirement Board Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico.

A quorum was present, as follows:

Members Present:

Mr. Bruce Malott, Chair
Ms. Jan Goodwin
Mr. James B. Lewis

Members Excused:

Mr. Gary B. Bland

Other ERB Members Present:

None.

Legal Counsel Present:

Mr. Chris Schatzman

Staff Present:

Mr. Mark Canavan, Real Estate Portfolio Manager
Mr. Bob Jacksha, CIO
Ms. LeAnne Larrañaga-Ruffy, Investment Officer
Mr. Steve Neel, Portfolio Manager
Mr. Jeffrey Riggs, Deputy Director

Others Present:

[See sign-in sheet.].

APPROVAL OF AGENDA

Ms. Goodwin moved approval of the Agenda, as published. Mr. Lewis seconded the motion, which passed by voice vote.

APPROVAL OF MINUTES: 04/09/08 & 4/22/08

Ms. Goodwin moved approval of the April 9 and April 22 minutes, as submitted. Mr. Lewis seconded the motion, which passed by voice vote.

INFRASTRUCTURE—APPROVE INFRASTRUCTURE INVESTMENTS: ERB STAFF AND COURTLAND PARTNERS

Mr. Canavan stated that, with the current credit crisis, he has been very concerned over contraction in the real estate sector and related sectors, so has spent considerable time analyzing them to ensure that the ERB's investments are of a highly defensive nature. He said the investments being recommended today have a tremendous amount of demographic demand and underlying demand regardless of credit availability.

Courtland Partners representative Steve Novick appeared before the Committee with Tom DeFranco, attorney and director of infrastructure at Courtland, and stated that Courtland is recommending approval of the first two investments in the ERB's infrastructure asset allocation program. He said Courtland spent many months vetting the majority of the funds in the market and worked with ERB staff to get the list down to a manageable few.

Mr. Novick noted that Courtland has recommended approximately \$3 billion in infrastructure investments to its clients over the last year.

Mr. Novick said that, in terms of portfolio construction, Courtland's goals are to obtain diversification for the ERB through different managers in diverse strategies, to obtain core value returns in the 10-15% net range, obtain current yield over the term of the investment, and to provide contrasting strategies.

Alinda Infrastructure Fund II, L.P.

Mr. DeFranco recommended a \$50 million investment in Alinda Infrastructure Fund II.

Mr. DeFranco said Alinda has excellent management team strength, a disciplined investment strategy, and the Fund offers a high current yield—for the

first three years, Alinda expects a 6-8% current yield and hopes that by Years 3 and 4 the Fund will be averaging 10%. He added that Fund I has reached a 10% annual yield at this point.

Mr. DeFranco said there are 5 principals on the management team with an average of 19 years of experience. He stated that Courtland is impressed that the team worked together before for 12 years, and prior to forming Alinda Fund I and Fund II generated a track record with a 26% IRR. He said that the team collectively has participated in \$150+ billion of infrastructure transactions in more than 75 countries, and commented that a management team with this depth of experience is hard to beat. He noted that they have international experience across different infrastructure sectors as well as having experience on both sides of the table from financing structuring to operating these assets.

Mr. DeFranco said Courtland likes the fact that they are independently owned and do not have exposure to the typical conflicts of interest that come with some bank-sponsored or public financial institution funds.

Addressing concerns, Mr. DeFranco said Fund II has a lifespan with two options: either invest for 10 years, or elect at a certain point to participate in the Fund for 20 years. He said that, based on the current ages of the five principals, Courtland thinks there should be some type of succession plan in place to assure investors who will be there at the end of the Fund to take care of business.

On another concern, Mr. DeFranco said that the market is frothy right now, but Courtland is comfortable with Alinda's strategy of focusing on medium sized transactions and the fact that they try to do things on a negotiated basis rather than go into auctions, where pricing and valuation can be unreasonable.

Mr. DeFranco also noted that 75% of the Fund will focus on North America, and while there is a short but established track record in Europe, Canada and Australia, there is not much of an established track record in the U.S. He added, though, that as time goes on and infrastructure becomes more prevalent in the U.S. economy, Courtland feels that issue should diminish.

Sanjay Khetry and Philip W. Dyk, partners with Alinda, appeared before the Committee and presented slides.

Mr. Dyk said Alinda Capital Partners was the first to launch an infrastructure fund in the U.S., three years ago, and so has an early mover advantage with Fund I and wants to continue with the relationships and momentum it has created. He said Alinda has an outstanding investment record, with more than 20 years of experience in 43 infrastructure assets worth nearly \$12 billion.

Mr. Khettry commented that Alinda sees infrastructure as a broad, sustainable and very long term secular trend that will pervade for the next 20 years because of underlying demographics and the inability of governments to finance investments in this area because of other demands (healthcare, education, etc.). He said the current credit crisis has also accentuated those issues as local municipalities and states are unable to afford, or are unwilling, to do waterworks and other infrastructure programs and to do necessary upgrades to their facilities. He said governments that previously were willing to put a lot of dollars into infrastructure through tax-exempt financing or other investment vehicles are now finding their budgets squeezed and financial markets disturbed. He commented that Alinda sees this as a major global trend that will accelerate over time.

Mr. Jacksha noted that Alinda intends to use 65-75% leverage at the company level long-term, and asked if the current credit situation will have any impact on what Alinda can do in terms of the availability and cost of credit.

Mr. Dyk responded that the access to capital continues to be very strong for infrastructure partly because of the nature of the asset. He said there are real assets as well as well-defined revenue streams either under contract or as part of a monopoly in the case of regulated utilities. He said the availability of capital and the change in capital availability to other markets is not as dramatic for infrastructure as it might be in real estate and certain other markets. He said credit markets have tightened, though, and so Alinda believes its strategy associated with using a fairly conservative debt equity structure will continue. He said Alinda may initially invest a little more equity and then re-lever it two or three years down the road when the markets have settled.

Mr. Khettry stated that Alinda has participated in only one public auction. He said they have control positions in all but one investment, British Airways, which was a very large negotiated transaction.

Mr. Khettry said the Fund 1 portfolio companies operate in 14 U.S. states, 10 Canadian provinces and 5 European nations. He said the Fund I portfolio companies serve 160 million customers in the areas of transportation, regulated water and gas utilities, and other essential services.

Mr. Khettry described the companies in the Fund I portfolio.

Mr. Lewis asked Mr. Dyk where the U.S. ranks in terms of maintaining its infrastructure, and Mr. Dyk responded that one engineering society in particular gives the United States D's and F's. He said a lot more money needs to go into water compliance, wastewater discharge, transmission systems, and other infrastructure areas.

Mr. Dyk also explained that the models for infrastructure investment vary from sector to sector. He said there are companies with models like Alinda's that want to invest, and it is happening more because there isn't the capital in certain situations, or there is an allocation of a service that can be done in a privately-owned company more efficiently than in a public sector company.

Mr. Lewis asked what the downside is in investing in infrastructure, and have there been any investment failures.

Mr. Dyk responded that he could not think of any downside, unless there is an asset that is not well maintained that will ultimately have problems associated with its efficiency. He said that is one of the reasons why Alinda makes sure it has a good maintenance program in looking at an investment.

Mr. Khettry said Alinda does not invest in greenfield road construction, for instance, because Alinda prefers seasoned assets. He said Alinda's Alabama assets are 7-12 years old and have gone through their "teething" issues. He added that, when Alinda looks at regulated utilities, they look for friendly jurisdictions because they also have to manage political risk, regulators, local municipal authorities and technology.

Mr. Dyk and Mr. Khettry confirmed that Alinda has no pending litigation issues.

Ms. Goodwin asked how Alinda hedges against foreign currency risk, given the amount of investment they have outside of the U.S.

Mr. Dyk responded that they primarily hedge by borrowing in the currency that the revenue stream is invested into. He said their revenues and their borrowing in South Staffordshire (UK) are denominated in pounds sterling, both revenues and borrowing. He added that they might hedge a position relative to the equity investment if judged economically feasible, but with the understanding that the equity value has to be kept whole because they are managing the revenues and expenses in the company itself.

Mr. Jacksha asked Courtland to discuss the preferred return and terms discussed in its report.

Mr. DeFranco responded that Mr. Jacksha was referring to Fund I, where the preferred return was 10 percent. He said Alinda did an industry analysis when developing the terms for Fund II and decided on an 8 percent preferred return after observing that this was consistent with the market.

Mr. Malott asked if the owners and managers of the Fund have their own money invested, and Mr. Dyk responded that they do.

Mr. Neel asked how Alinda's traffic models have tracked with the increase in fuel costs.

Mr. Khettry responded that it depends on the road; for example, the Detroit-Windsor Tunnel is episodically affected by currency movements and casino activity. He said the discretionary traffic went away following 9/11 because of passport controls and other border issues; however, this is a commuter road and there is a great deal of resilience through toll increases or gas price increases.

Mr. Lewis moved that the Real Estate Investment Committee approve a commitment of \$50 million to Alinda Infrastructure Partners Fund II, L.P. subject to and contingent upon New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate paperwork.

Ms. Goodwin seconded the motion, which passed by voice vote.

CITI Infrastructure Partners, L.P.

Mr. DeFranco recommended a \$50 million investment in CITI Infrastructure Partners ("CIP"), L.P.

Mr. DeFranco said CIP has an excellent management team with two co-heads, Juan Bejar and Felicity Gates, who respectively have 25 years and 18 years of infrastructure experience and are supported by four other principal partners. He said the team has offices in New York and London with a vast network.

Addressing strengths, Mr. DeFranco stated that CIP's commitment to this \$4-\$5 billion Fund as a limited partner will equal the lesser of \$500 million or 17.5% of the money raised for the Fund, and they will be treated just like the rest of the other LPs.

Mr. DeFranco said Courtland feels that CIP's abilities to source new deals for the Fund through their global network, along with the backgrounds of these individuals in their prior experience, will create opportunities for them to use their competitive advantage.

Addressing concerns, Mr. DeFranco noted that CITI is a publicly traded company and is taking a lot of heat from the subprime mortgage market, but the team has done a great job of trying to show that they are isolated from the parent company. He said the team believes their assets are not accessible to the parent company, but if something like that should happen as a result of a huge financial hit, they believe the Fund itself would be able to continue to operate the assets the ERB might be invested in.

Mr. DeFranco said there is also operational risk, since these are operating companies that run the assets, and there could be some control weaknesses or management issues that may not be foreseeable.

Mr. DeFranco commented that \$5 billion is a considerable amount of capital to deploy, assuming CIP succeeds in raising that amount, but Courtland feels the team does have the experience necessary to put this to work and to do it competently.

Co-head Felicity Gates appeared before the Committee and reviewed the details of the Fund and the team strategy.

In discussing the key components of CIP's strategy, Ms. Gates said they plan to invest in very large, very stable and very core deals in traditional infrastructure. She said they also are targeting very developed markets with very well developed property ownership rights (to be able to enforce contracts) in the U.K., Western Europe, U.S., Canada and possibly Australia.

Ms. Gates pointed out that there is less competition for the largest deals because they are so complicated to put together, so superior returns are attainable.

Ms. Gates said CIP wants to put together platform companies and do fewer than ten deals in this Fund, and their ideal investment size for a single deal will be about \$1 billion. She said they want management control so they can drive operations and the capital structure of the deals.

In explaining CIP's platform concept, Ms. Gates said they put together a best-in-class management team when they acquired Kelda, for example, which owns Yorkshire Water in the U.K., and they are now are working with that team to look at ways of using them as a platform in the sector.

Ms. Gates discussed investment highlights of the pending \$12.8 billion Pennsylvania Turnpike deal, which is still subject to legislative approval. She said this 500-mile toll road makes up ten percent of the toll roads in the U.S., and the State of Pennsylvania wants to take the money they get from the lease, give it to the state pension fund to invest, and take the \$1 billion in annual proceeds from that to upgrade the 5,000+ deficient bridges in that state.

Mr. Malott asked Ms. Gates to discuss a recent Barron's article that said Pennsylvania should take the deal now before CIP changes its mind, the implication being that CIP is paying too much.

Ms. Gates responded that, had the road been sold 12 months ago, the state would have gotten a higher price in different debt markets, and they know that. She

said a Morgan Stanley analysis came up with a figure of \$12-\$18 billion, and CIP is at the bottom end of that range for three reasons: 1) the term of the concession is 75 years, midway between the usual 50 and 99 years; 2) The Pennsylvania Turnpike Commission plans to raise tolls by 25% in January 2009 and then by about 3% annually with no commitment to cap the tolls. The Commonwealth decided to put in the lease agreement that CIP would have the 25% increase in January, but after that leases would be annually capped at the lower of either inflation or 2.5%. Ms. Gates said this increase calculation is less than it is in different parts of the country, so it kept CIP at the bottom end. 3) The state of the credit markets, which benefits anyone who is invested at the moment because the assumptions made in a prudent model relate to the financing in place at the time of sale, but when markets settle down a bit, then CIP would expect upside in the refinancing.

Ms. Gates commented that the CIP team was actually pleased to see the article, because to get the legislation through they'd like them to be in that position. She also stated that CIP sees the price as very reasonable on both sides of the table.

Mr. Jacksha noted that there is some sensitivity in the U.S. to foreign ownership of some of these assets—Dubai, for instance—and asked if that is a potential concern in terms of who their other LPs are.

Ms. Gates responded that there are a number of U.S. investors looking at it, along with a smattering from different places, including Australia and Europe, and two from the Middle East along with the Singaporean government. She added that the sovereign wealth funds have become much more conscious of this and there have been delegations sent to Washington to discuss the issue.

Ms. Gates commented that one of the benefits that CITI brings is that they are an American manager and operator, and in the Pennsylvania Turnpike transaction will bring in all of the investors behind them. She said there is a less of a worry in this case because a toll road can't be taken away, which is one reason why CIP doesn't invest in emerging markets—it can't take an asset back if it isn't paid for.

Mr. Lewis asked Mr. Canavan why this investment recommendation comes so highly recommended.

Mr. Canavan responded that he spent four hours grilling Ms. Gates and was extremely impressed with her expertise. He commented that Ms. Gates was previously managing director and head of North America for Deutsch Bank Group, and at RREEF had launched both a North American and a European infrastructure fund.

Mr. Lewis moved that the Real Estate Investment Committee approve a commitment of \$50 million to CITI Infrastructure Partners, L.P. subject to and contingent upon New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate paperwork.

Ms. Goodwin seconded the motion, which passed by voice vote.

**REAL ESTATE—APPROVE REAL ESTATE INVESTMENTS:
ERB STAFF & ORG**

Prima Mortgage Investment Trust, LLC

Steve Gruber, adviser with ORG Portfolio Management, recommended a commitment of up to \$50 million in Prima Mortgage Investment Trust, a commercial mortgage fund.

Mr. Gruber commented that ORG has been fairly negative on the “core real estate space,” which comprises four major property types (office, retail, apartments and industrial), because pricing has become so aggressive. He said ORG has been looking for an alternative in terms of how to generate income and exposure to the asset class with the least risk to preserving capital. He stated that, because of the destruction of the capital markets, ORG began investigating the universe of fixed income or debt opportunities that were available.

Mr. Gruber said they looked at more than thirty funds on behalf of ERB. He said many of these funds are focused on high yield opportunities, and the investment strategy of the manager is to further enhance the risk and potential return through the use of leverage. He said ORG decided to recommend a more conservative strategy that deploys no underlying leverage to enhance returns, and narrowed the list down to five or six managers who are real estate experts and will actually go out and look at properties do the necessary analyses around location, tenant profile and competitive advantage.

Greg White, founder and principal in Prima Mortgage Investment Trust, presented slides.

Mr. White stated that Prima does not invest in hotels/motels, land deals, casinos, development or renovation. He said they only invest in U.S.-based property, and specifically in the lower 48 states.

Mr. White stated that, since inception, Prima has consistently outperformed its clients' performance benchmarks, and the firm has had only one loss (\$2 million) on investments of over \$3 billion since 1995.

In addressing Prima's investment strategies, Mr. White said their business is driven by personal service, and their clients speak directly with one of the principals and not with a marketing professional or analyst. He also stated that Prima's portfolio only invests in CMBS and REIT bonds rated investment grade (BBB- or above) and high quality commercial mortgage whole loans and B/Mezzanine notes.

Mr. White noted that, since inception, Prima has issued five securitizations, and every one of these deals has been upgraded at least once by all of the major rating agencies.

Mr. White stressed that Prima has nothing to do with subprime mortgages.

Mr. White said Prima outsources its loan servicing to Midland, the second largest loan servicing organization in the country.

Mr. Lewis asked if there is any pending litigation against Prima, and Mr. White responded that nothing is pending and the firm has never been sued.

Mr. Jacksha commented that there have been a number of internal conversations with Mr. Gruber on how to address the current real estate market. He said staff thinks the approach of underwriting each individual property is a good one as opposed to just buying securitized real estate.

Mr. Canavan added that staff sees this approach as a very defense one in the current real estate market.

Mr. Lewis moved that the Real Estate Investment Committee approve a commitment of \$50 million to PRIMA Mortgage Investment Trust, LLC, with \$25 million of this investment to be deployed immediately and with the \$25 million available on call, subject to and contingent upon New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate paperwork.

Ms. Goodwin seconded the motion, which passed by voice vote.

**PRIVATE EQUITY—APPROVE PRIVATE EQUITY INVESTMENTS:
ERB STAFF AND ALDUS EQUITY**

Levine Leichtman Capital Partners IV, L.P.

Mr. Neel reported that Levine Leichtman has returned over \$1 million from the ERB's prior investment in the firm's Deep Value Fund. He stated that, of their realized investments in this Fund, they have a 40+% IRR.

Aldus Equity Associate Saul Meyer reviewed an update of the ERB's Allocation Plan. He noted that, of the \$80 million allocation to the Mezzanine bucket, \$50 million is being proposed to Levine Leichtman. He commented that this is a strong-returning fund with very little downside and low volatility.

Aldus Equity Associate Drew Crichton stated that Aldus is recommending a \$50 million investment in Levine Leichtman, which is seeking to raise a \$1 billion structured equity fund that focuses on U.S. enterprises in the lower middle market with revenues between \$100 million and \$500 million. He said the strategy remains the same as in the previous three funds.

Mr. Crichton said the firm is comprised of 46 people located in four offices: Los Angeles (main office), Dallas, Chicago, and New York. He said the investment team is organized into two groups: Originations, which sources and evaluates new investment opportunities; and Investment Monitoring and Realizations, which structures, executes, actively monitors and exits the investments.

Mr. Crichton said the five Partners have worked together at LLCPC since 1996 and bring significant investment experience, stability and cohesiveness to the management of the Fund.

Mr. Crichton stated that LLCPC has invested approximately \$873 million across its three prior structured equity funds; and as of March 31 this year, the firm's investment had a total value of \$1.3 billion, representing a gross IRR of 23.3% and 1.5x multiple on investment capital.

Mr. Meyer noted that there has only been one investment to date that has lost money across all of LLCPC's funds, which attests to their remarkably low degree of volatility.

Arthur Levine and Lauren Leichtman, the two founding Partners, presented slides.

Ms. Leichtman said LLCPC currently has 23 fully realized deals with 46% IRRs; and on those realized deals, they have a 2x return of capital.

Ms. Leichtman also noted that, from 1984 through 1993, they made seven investments (pre-fund) which have all been realized and generated a 452% gross IRR.

Mr. Neel asked the Partners to discuss their monitoring process.

Ms. Leichtman responded that their Investment Monitoring and Realizations group is headed on a day to day basis by Kim Pollack and Aaron Perlmutter, both of

whom have carry in the Fund and have private equity backgrounds, and they work closely with CFO Steve Hogan and general counsel Steve Hartman.

Ms. Leichtman said they meet with their portfolio companies on a monthly basis; and when they are doing due diligence, they talk with management teams and ask them to identify their critical operating factors that drive the creation of the cash flow. She said LLCP takes that information and asks them to covenant to those operating factors in their documents.

Mr. Levine stated that, since submittal of their documents to Aldus and the ERB, LLCP has lowered their management fees from 1.875% to 1.75%, their post-investment fee from 1.65% to 1.5%, and have increased their preferred return from 7% to 7.5%. He added that, while they have been back to the market about every four years and their commitment period is a bit longer, they generally invest their money in a shorter period of time.

Mr. Lewis moved that the Private Equity Investment Committee approve a commitment of \$50 million plus any notional interest to Levine Leichtman Capital Partners IV. The commitment shall not exceed 20% of the committed capital of the fund and is subject to and contingent upon New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate paperwork.

Ms. Goodwin seconded the motion, which passed by voice vote.

NATURAL RESOURCES INVESTMENT POLICY & PROCEDURES: ERB STAFF & ORG

ORG representatives Steve Gruber and Howard Kaplan appeared before the Committee.

Mr. Gruber noted that natural resources comprises 1.5% of the ERB's total portfolio, and the objective is to generate attractive returns that diversify the overall portfolio from segments of the economy that normally the ERB isn't exposed to through private equity common stock in real estate.

Mr. Gruber stated that the benchmark for the portfolio, as shown in the policy, mirrors the real estate policies that the ERB already has in place. He said the natural resources portfolio is expected to generate returns, net of all fees and expenses, in excess of the NCREIF Index for Timberland (50%) and Farmland (50%) over rolling five-year investment time horizons.

Mr. Kaplan also noted the following target allocations: Global Timber, 40%; Global Agriculture, 40%, and Domestic Mitigation Banks, 20%. He said

diversification geographically would be about 50% Northern Hemisphere and 50% Southern Hemisphere.

Mr. Kaplan said other areas of diversification would be derived from vintage year diversification, by timing some of the investments in different years; manager diversification, where no single manager would be allocated more than 30% of the portfolio if in only one segment, but could be raised to 40% if a single manager had allocations in more than one segment; and diversification by strategy (different types of crop, different types of timber and mitigation banks).

Mr. Gruber stated that ORG is meeting with managers and expects to have a fund before the Board in August or September with Greenfield, an approved real estate manager, for co-investing in mitigation bank strategy.

In the course of discussion on the NCREIF Index, Mr. Gruber explained that there is no index for mitigation banking, but its objective is to be superior to the blended aggregate in timber. He said the only deals in mitigation banking that ORG plans to bring to the ERB will exceed the agricultural and timber index (50-50 blend).

Mr. Lewis moved recommendation of approval. Ms. Goodwin seconded the motion, which passed by voice vote.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at approximately 4:15 p.m.

Accepted by:



Mr. Bruce Malott, Chair