

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
INVESTMENT COMMITTEE

December 10, 2008

CALL TO ORDER

A meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at approximately 2:25 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
Mr. Gary B. Bland [teleconference]
Ms. Jan Goodwin

Members Excused:

Mr. James B. Lewis

Other ERB Members Present:

None.

Legal Counsel Present:

None.

Staff Present:

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

Others Present:

Mr. Holland Gary, Aldus Equity
Mr. Steve Gruber, ORG
Mr. Saul Meyer, Aldus Equity

APPROVAL OF AGENDA

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

APPROVAL OF MINUTES: November 20, 2008

Ms. Goodwin moved approval of the November 20 minutes, as submitted. Mr. Bland seconded the motion, which passed by voice vote.

PRIVATE EQUITY UPDATE: NMERB STAFF

Mr. Neel reported that the Fund now has 22 partnerships with a market value of approximately \$150 million and commitments exceeding \$500 million.

Mr. Neel referred to a draft ERB 2009 schedule. Given the Board's intent to combine the Private Equity Committee and Investment Committee, he said staff is suggesting that the combined meeting be held on the second Thursday of each month at 1:00 p.m.

PRIVATE EQUITY: APPROVE PRIVATE EQUITY INVESTMENTS

December 2008 Allocation Plan Update

Saul Meyer of Aldus Equity Partners reviewed an updated 2008 Allocation Plan for the ERB.

a) Lee Equity Partners Fund, L.P.

Mr. Meyer introduced Tom Lee, David Morrison and Ben Hochberg, partners in Lee Equity Partners.

Mr. Meyer said Aldus is recommending a \$30 million commitment to this Fund, which is targeting \$2.5 billion but which Aldus expects to close out at between \$1.3 billion and \$1.5 billion.

Addressing Tom Lee's prior track records, Mr. Meyer stated that Mr. Lee has produced top quartile returns with cumulative IRRs of 26.8%, with a focus on media, business services, retail and consumer products. He noted that, although this is a first time Fund, this is certainly not a first time team. He said Tom Lee founded THL Partners in 1974 and experienced an incredible degree of success

over time; and in 2006, after leaving THL and selling his interest, Mr. Lee formed Lee Equity Partners with a strong team. He stated that at least three come from working together at Bain Capital, including Mr. Hochberg. He said Aldus sees very strong team cohesion.

Highlighting investment strategy, Mr. Meyer said Lee Equity Partners is targeting companies in the mid market with enterprise values ranging from \$500 million to \$3 billion and will make equity investments between \$100 million and \$500 million. He added that a differentiator is that they are targeting companies that are growth oriented.

Mr. Meyer said one of Lee's senior advisors is Allen Questrom, former CEO of J.C. Penney, Neiman Marcus and Barney's. He said another senior advisor is Robert Wright, former chairman and CEO of NBC.

Mr. Meyer reviewed the track records of Tom Lee, Mark Gormley, Ben Hochberg and Yoo Jim Kim.

Discussing terms, Mr. Meyer said the Fund features a 70/30 transaction fee offset to the management fee, while Aldus believes that 80/20 is the market standard and likes to see a full 100% fee offset. He added, however, that the GP contribution is extremely large in this case, at 5% up to \$150 million, which gives Aldus a lot of comfort; and in addition, in one of the two investments already made for the Fund, although the asset has already been marked down in value, the Fund is backstopping the value of that investment, which guarantees that the investors will recover their cost.

Mr. Malott asked Mr. Lee to discuss, among other things, why private equity is still a good place to invest money.

Mr. Morrison and Mr. Hochberg discussed their backgrounds.

Mr. Lee reviewed a timeline of his equity investments since 1974. He commented that people make private equity investments because the returns should be significantly higher. He said his firm is small cap to mid cap, so correlates to the Russell 2000, which has been at 11-12% in small cap public stocks for the last 50 to 70 years. He said the firm previously felt they had to return at least 1000 basis points over the index, and today feels it should be 1500 points over the index.

Mr. Lee said this Fund should have 10-15 deals, and he reviewed potential investments that the firm is considering. He stated that staff is very focused on these deals. He reviewed the strategies that the firm has employed in various market conditions since 1974 in proprietary transactions, operating improvement, multiple arbitrage and financial engineering. He said the firm is not doing financial engineering at the current time.

Mr. Lee stated that there will be very little traditional activity in the large cap space for several years, and the firm sees a lot of financing available in the mid cap space, and from all sources up to \$1 billion. He said banks will finance, and some of the better hedge funds are still in the business, and many insurance companies still have mezzanine money.

Mr. Malott referred to a December 4 *Wall Street Journal* article describing that Thomas H. Lee's Fund-of-hedge funds has suffered significant losses during the current year, and asked him to explain any relationship, legal or otherwise, between Lee Equity Partners and Blue Star.

Mr. Lee responded that he has been investing in hedge funds for about ten years through Blue Star, a levered fund-of-funds. He stated that he is not working at Blue Star, and his entire focus is the private equity business, where he spends 100 percent of his time.

Mr. Morrison asked Mr. Lee if there is any connection between Lee Equity Partners and Blue Star in terms of people, economics, legal entities or cross funding, and Mr. Lee responded no.

Ms. Goodwin moved that the Investment Committee approve a commitment of \$30 million, plus any notional interest, to Lee Equity Partners Fund, L.P. 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.

Mr. Bland seconded the motion, which passed by voice vote.

b) Veronis Suhler Stevenson Structured Capital II, L.P.

VSS Structured Capital co-manager George Cole, managing partner Jeff Stevenson and managing director Jim Rutherford were introduced to the Committee.

Aldus Equity Associate Holland Gary stated that Aldus is recommending a \$40 million commitment in Veronis Suhler Stevenson Structured Capital II. He said this is a \$300 million media-focused structured capital or mezzanine fund. He noted that the VSS brand name has been highly active and highly respected in the media space for 30 years, and this Fund is being built upon that platform.

Mr. Gary stated that, as of September 30, 2008, VSS Structured Capital Fund I was generating a 35.5% gross IRR and a 1.6x return on invested capital. He noted

that the performance includes two strong exits as well as active portfolio companies that have all generated either substantial capital returns or a markup of investment value.

Mr. Gary stated that VSS was formed in 1981 as an investment bank devoted exclusively to media, and commenced its private equity business in 1987. He said VSS Structured Capital was established in 2005 as an extension of the firm's leading position as a media sector investor. He noted that the Fund is supported by the entire VSS platform, from sourcing and due diligence to strategic/operational guidance and add-on acquisition candidate evaluation.

Mr. Gary stated that Fund II will invest in a diversified portfolio of established and profitable media companies and will structure each portfolio company investment to provide both a fixed return and an equity component. To accomplish that, he said the Fund's investments will usually involve both debt and equity instruments such as warrants. He said this approach provides flexibility in terms of approaching companies and meeting the needs of various entrepreneurs. He said a debt-oriented instrument protects the downside, while the warrants provide a lot of the upside, and VSS's track record reflects that.

Reviewing the Fund I track record, Mr. Gary noted no write-downs or write-offs, and a tremendous amount of consistency with a number of investments performing well over the 20% mark, which is typical of mezzanine strategies.

Messrs. Cole, Stevenson and Rutherford presented slides.

Mr. Cole pointed out that a typical mezzanine fund takes debt-like approach and markets to other financial sponsors in a transaction, so it essentially becomes a competitive process. He added that, while that can be effective in putting money to work, VSS has that going direct to companies and sourcing its own transactions gives them a much better return profile because they are viewed much more as a company's partner rather than another private equity fund's debt provider.

Mr. Cole said VSS is very active with its companies, and sits on the boards of all companies either actively or as observer. He said they continually evaluate acquisition opportunities and corporate initiatives with these companies, and in cases where companies do not meet their business plans, VSS learns about it firsthand as opposed to finding out after the fact when it is necessary to trip the covenants.

Mr. Cole stated that the ERB will get the full VSS team with Fund II. He said a typical mezzanine fund has five or six investment professionals; but because VSS has its private equity practice, it can have as many as twenty senior level people, between partners and managing directors, looking at deals, sourcing deals, helping with due diligence, and serving on the boards with VSS.

Mr. Malott asked where the deal flow and opportunities are for VSS, and Mr. Stevenson responded that they see three distinct sectors: information services, media and education. He said those break down into 40 sub-sectors and this has grown fairly consistently over time 100-200 basis points faster than the overall GDP.

Mr. Stevenson added that the traditional segments that VSS invested in twenty years ago—TV, radio, magazines and newspapers—are not the areas VSS tends to focus on today. He said they focus on newer media businesses that have at least some online component, which is growing at 15+% annually; and information services, which tend to be more data intensive and subscription driven with annual renewing revenue streams. He said half of what VSS does in its current funds is digital or new media in some form, and less than 30% is advertising driven.

In terms of deal flow, Mr. Cole said Fund II stands to benefit from the state of the credit markets today. He stated that, of the three of the deals they currently have and expect to close in January or February 2009, two of them probably wouldn't have been opportunities for VSS in the robust credit market of a couple of years ago because they would have been undone entirely in the bank market or the second lien markets. He said these opportunities are now available to VSS because VSS is a source of capital that is much more relevant today than it was two years ago. He added that VSS is now seeing larger companies with much more limited access to capital than in the past.

Mr. Bland said he liked this sector and this approach.

Ms. Goodwin moved that the Investment Committee approve a commitment of \$40 million, plus any notional interest, to VSS Structured Capital II, L.P. 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.

Mr. Bland seconded the motion, which passed by voice vote.

**REAL ESTATE—UPDATE ON GUGGENHEIM III: GUGGENHEIM
PARTNERS,
ORG AND ERB STAFF**

Mr. Canavan stated that there has been a substantial dislocation in the market, with a lot of mark-to-market pricing being so inaccurate that people are unwilling to trade at those prices, and FASB is trying to resolve this situation. He commented

that, as a result, there is a tendency to overstate the reality of the underlying properties within a security.

Mr. Canavan introduced Grant Rogers of Guggenheim Partners, who would discuss the impact of this phenomenon on Guggenheim Fund III.

Also present was Steve Gruber of ORG.

Mr. Rogers stated that Guggenheim III is a \$1.25 billion private equity fund that invests in commercial real estate debt. He said the ERB has invested \$25 million, representing about 2% of the overall Fund; and to date, all but \$3 million of that has been called.

Mr. Rogers said they began investing in November 2007, when they saw what they believed to be an incredible opportunity, but in hindsight believe they began investing about six months too soon.

Mr. Rogers stated that, as of September 30, 2008, they have made 41 investments of about \$2 billion with about 42%, or \$800 million, of leverage.

Mr. Rogers said their investments on average begin at about the 34% loan-to-value point and run through 50% loan to value, so this is a fairly safe place to invest in the market.

Mr. Rogers said debt coverage overall for the Fund is about 2.6x and the NOI yield is nearly 16%, so these are good performing assets.

Mr. Gruber asked what percent of their assets are performing today, and Mr. Rogers responded 100%.

Mr. Rogers commented that what is happening in the market today is unprecedented and began with the collapse of Bear Stearns in February 2008. Citing some examples of the effect, he said they bought equity office property bonds at 0-44% LTV at 90 cents, and while they expect to eventually get all of their money back, today the LTV is at about 65 cents.

Mr. Rogers said they are also in Manor Care, an AA rated term-funded transaction that they bought at 88 cents, and they are currently at 30-39% LTV and their debt cover is 4x. He stated that this transaction has General Electric and Health Care Properties behind it at \$1 billion apiece and is sponsored by Carlyle.

Mr. Rogers stated that they also invested \$125 million in Toys R Us, buying it at 95 cents, and the metric for that is about \$69 per square foot.

Mr. Rogers reviewed a chart reflecting the volatility in the capital markets along with historical events since January 2007 and the unusual spread on AAA CMBS.

Mr. Rogers commented that, as a result of the market, they have had an extraordinary number of margin calls from their repo lines; and it is not credit driven, because the assets are performing very well, but when AAAs are quoted at Swaps + 1500, the question is what a lesser security is worth.

Mr. Rogers said Guggenheim has about \$800 million worth of borrowings from various repo lenders that has broken down into seven parties. He added that, corresponding with the problems experienced by Citigroup a month ago, they have recently gotten about \$70 million in margin calls; and while Guggenheim could answer these calls with about \$150 million of its undrawn capital, they decided they could not allow themselves to be bled to death with possibly more margin calls, and so they have taken a hard line with their lenders by refusing to meet the margin calls. He said Guggenheim is consequently in default with some lenders, but has gone back to them and said they could meet the calls and pay down the lines, but they are not going to do that unless they can turn this into a non mark-to-market facility that just terms out for the entire term of the underlying assets.

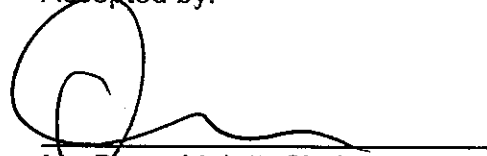
Mr. Malott asked Mr. Rogers how the lenders have reacted, and Mr. Rogers responded that, as of this morning, most were on board with Guggenheim in various ways. He said he thought a number of the lenders would agree to term out the facility until the assets mature, while JP Morgan and Goldman Sachs would probably take money and bow out.

In conclusion, Mr. Rogers stated that, by putting those assets into a separate entity, all of the assets would be recoverable; and by working with the lenders and keeping the other assets to maturity, the money would be saved, and that was a very good outcome in this market.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at approximately 4:10 p.m.

Accepted by:



Mr. Bruce Malott, Chair

