EMPLOYEES RETIREMENT SYSTEM OF TEXAS PRIVATE INFRASTRUCTURE PARTNERSHIP EVALUATION CRITERIA

I. Introduction

A key characteristic of the Private Infrastructure Portfolio is its illiquid nature. This illiquidity can benefit the total Infrastructure Portfolio and the System's total portfolio, as investors often shy away from illiquid investments allowing for attractive pricing for investors who are willing to take on private infrastructure's inherent liquidity risk.

Aside from the difficulty of unwinding Private Infrastructure Portfolio Investments due to their inherent nature, there is difficulty in tracking unrealized investment values. Private infrastructure valuations are conducted by valuation experts, who typically utilize a combination of valuation methodologies including: 1) discounted cash flow analysis, 2) replacement cost analysis, 3) comparative analysis using publicly traded securities and recent private transactions. Each of these approaches is susceptible to significant lag effect, as market pricing moves more quickly than private valuations. Private infrastructure is valued/appraised, at most, on a quarterly basis. Some investments are only appraised once per year.

II. Qualitative and Quantitative Evaluations

Intensive due diligence is essential prior to investment given the illiquidity of private infrastructure. Given both the lack of daily pricing and representative passive indices, the evaluation criteria applied to infrastructure investment opportunities is less statistically-driven than the evaluation of publicly-traded infrastructure. While significant analysis of past investments and realizations is performed, there are limited historical return series to analyze given the emerging asset class. The limited track record requires the evaluation of Private Infrastructure Investments to be more reliant on qualitative evaluation. A number of qualitative measures, similar to those used for public security managers, are available for analysis. Such factors include experience and tenure of professionals, turnover, organizational structure, client base, and investment process. Considerations specific to ERS' investment program, such as an infrastructure partnership's role or fit within the Infrastructure Portfolio, is also important.

III. Evaluation Criteria

The evaluation criteria are a first step in screening and identifying attractive investment candidates. Few Private Infrastructure Portfolio investments will achieve all the desired characteristics below. However, the evaluation criteria will provide insight into the identifiable strengths and weaknesses of partnerships, and the ability to conduct meaningful in-depth due diligence on investment opportunities. The evaluation criteria are a first step in screening and identifying attractive investment candidates. Partnerships that compare favorably to the evaluation criteria become candidates for full due diligence.

A. Track Record

Desirable characteristics include:

- The track record is ideally of sufficient length and number of companies to be meaningfully analyzed.
- The rate of return on prior investments, especially fully realized investments, should be attractive on both an absolute basis and in comparison to peers.
- There should be a pattern of steady capital deployment in each vintage year by number of companies and total disbursed.

- There should be a meaningful, analyzable number of realizations in the portfolio, preferably both through private sale and public offering, and during a variety of market conditions.
- Realizations should evidence reasonable holding periods and timely execution of business strategies.
- The historical track record must be attributable to the general partners who will manage the partnership going forward.
- The track record information must be consistent with and applicable to the proposed strategy for future investments.

B. Investment Professionals

Infrastructure partnerships are typically dependent on a small number of key professionals, accordingly:

- The investment professionals should have relevant and applicable backgrounds to the strategies and industries being pursued.
- Complimentary backgrounds and skill sets (e.g., investment banking, management consulting, and operating company experience) are viewed as positive in bringing different perspectives and experiences to the investment selection process and assisting companies in the execution of their business plans.
- Key personnel should have a long tenure of working together, and low or no turnover of key personnel is desirable.
- Infrequent selective additions of senior personnel to fill specific needs are desirable, as well as a demonstrated ability to promote from within are viewed as positive.
- The periodic addition of highly qualified junior professionals, at various skill levels, in a rational manner is viewed as positive.

C. Organization

As the organizational and administrative infrastructure must support the investment professionals' success, desirable characteristics include:

- Sufficient support staffing to provide a strong platform for the investment professionals, including accounting and finance, information systems, administrative support, and other back-office personnel as required.
- The firm should demonstrate controlled growth over time, as assets under management increase.
- The managing partnership should have a well-articulated plan to build resources to meet future requirements.
- Turnover in the non-professional ranks should be low.

D. Investment Strategy

Infrastructure partnerships typically approach investment strategies based on the general partners' specific business acumen and experience, so desirable indicators of a successful investment strategy include:

- The partnership should have a well-articulated and documentable investment approach that is consistent with the partners' business backgrounds and past investment successes.
- The strategy must be one that can be logically expected to continue to be successful in the future (e.g., investment opportunities persist, financial structures are viable, and continued commercial and capital market acceptance is expected).

- The investment professionals should have established successful methods of sourcing high quality transactions and/or unique sources of relatively proprietary deal flow.
- The investment strategy must have an identifiable value-creation proposition, including activist involvement with portfolio companies at the board and strategic planning levels.
- The partnership should be able to demonstrate a unique franchise or competitive advantage with respect to sourcing investments and/or executing strategy.
- Generally, partnerships sought will be well diversified by industry, geography, and number of companies, although there is flexibility to consider niche or specialty funds.

E. Assets Under Management

- The manager should have an institutional client base, preferably with other sophisticated pension fund investors, and preferably public pension funds.
- There should be evidence that prior investors will invest in the new partnership.
- Past partnerships and the proposed vehicle should be of sufficient size to be considered a truly institutional partnership, typically $200 million or more.

F. Business Practice Management

While not a key initial evaluation criterion, the manager must demonstrate that it has the ability to perform all tasks necessary to be a successful business entity ongoing, including:

- Ability to be credible in the market place and raise sufficient assets for the proposed fund and future partnerships.
- Performance of all portfolio management functions associated overseeing the individual company investments and total portfolio through to a timely realization.
- Demonstrate responsive reporting and client service for investors.
- Evidence a cohesive corporate culture and stable organization.

G. Fit Within Strategic and Tactical Plans

ERS has a substantial portfolio with relationships in most strategies. New relationships are evaluated as to whether:

- They fill an identified under-weighting in the portfolio's strategic portfolio structure.
- They are identified as an area of focus in the Annual Tactical Plan.
- They are partnerships with a top tier franchise, which have the potential to improve the portfolio's overall rate of return.

H. Terms and Conditions

- Partnership Size – The prospective partnership must be of a size that is consistent with the historical investment run rate of the firm, adjusted for reasonable growth as determined by an assessment of the firm's capacity to manage new investments.
- Economic Terms – The economic terms of the fund must be market-based taking into account factors such as the firm's size, strategy, and track record.
- Governance Provisions – While primarily conducted by ERS' legal counsel in final documentation, the initial term sheet should include investor rights that are market-based taking into account factors such as the firm's size, strategy, and track record. Examples of typical governance provisions viewed as favorable would include key person clauses, change of control clauses, limited partner advisory boards, and general partner carried interest clawbacks, among others.

I. Consideration of Emerging Fund Managers

- ERS will make a good faith effort to award contracts to or acquire services from qualified emerging fund managers when acquiring private financial services as directed by House Bill 2559 from the 81st Legislature, which added subsections (g), (h), and (i) to Section 815.301 of the Texas Government Code.
- An emerging fund manager is defined as a private professional investment manager with assets under management of not more than $2 billion. Private financial services include pension fund management, consulting, investment advising, brokerage services, hedge fund management, infrastructure fund management, and infrastructure investment.
- ERS reports to its Board of Trustees the methods and results of its efforts to hire emerging fund managers, including data disaggregated by race, ethnicity, gender, and fund size.