Private Real Estate Portfolio Annual Tactical Plan

Fiscal Year 2023

MEKETA
INVESTMENT GROUP

MEMORANDUM

TO: Board of Trustees – Employees Retirement System of Texas
FROM: Meketa Investment Group ("Meketa")
DATE: August 2022
RE: Private Real Estate Portfolio Annual Tactical Plan for Fiscal Year 2023

Preface

The proposed Private Real Estate Portfolio Annual Tactical Plan ("Plan" or "the Plan") for Fiscal Year 2023 (September 1, 2022 through August 31, 2023) was prepared by Meketa Investment Group in collaboration with Employees Retirement System of Texas ("TX ERS" or "System") Staff during July 2022. The frame around the Plan's picture is the beginning of the transition towards a "new normal" after more than two years of global COVID pandemic, and the resulting potential implications for commercial real estate investments. The widespread availability of immunizations, therapeutics and testing is currently supporting the lifting of mask mandates in many places. Traffic to offices, retail shopping centers, restaurants, entertainment venues and hotels is expected to increase as a result, although it is unclear as to the pace and to what portion of pre-pandemic levels activity levels will return. Different locations and property types' experience will vary considerably, even in the same generally accepted statistical metro areas. Therefore, it is important to remain alert to changing space utilization patterns advanced by the presence of the virus, technology, and employment levels and trends. Always a "local" business, individual real estate assets' performance will vary based on intrinsic and exogenous forces. The long-term nature and generally lower correlated performance of privately held commercial real estate versus publicly traded securities provide institutional investors with comparative diversification and return benefits. As always, though, to quote Linda Loman, "Attention must be paid."

Additionally, Russia's invasion of Ukraine continues unabated with no visibility into the eventual outcome. Heavy sanctions by the West are creating economic havoc in Russia, with significant knock-on effects to global supply chains, and in particular oil and natural gas. Inflation in the U.S., which had been ticking up in 2021, but was believed by many in policy creating roles to be largely transitory. Reasoning was that it occurred as a result of COVID-related supply chain disruptions. WRONG! The notion of inflation is now entrenched, and a whole new generation of investors and consumers is dealing with it for the first time. In addition to higher prices and material shortages, the markets have experienced multiple Fed funds' rate hikes in 2022 and more are expected.

While most domestic real estate market locations and property types demonstrated remarkable resilience and posted record returns in 2021, there remains material uncertainty across almost all geographic real estate markets during the next 12-24 months. The Annual Tactical Plan contained herein is highly subject to change.

On the plus side, several factors mitigate these conditions and offer optimism for this vintage. The role of private real estate is clear within the overall System's portfolio construction. The System has the ability to take risks when and where the returns warrant. Finally, Staff is experienced, thoughtful and manages the real estate plan holistically through investments in well-structured, well-led commingled funds and associated co-investment vehicles. Despite the turmoil of the past 24 months, Staff has continued to steadfastly focus and execute the construction of the portfolio, and retain the team and its productivity.

Executive Summary

Staff will continue committing capital to private real estate on a highly selective basis, and currently targets up to $200 million in commitments in each of fiscal years 2023 and 2024 as seen in Exhibits 1 and 2.

Exhibit 1 – TX ERS Commitment Schedule by Strategy

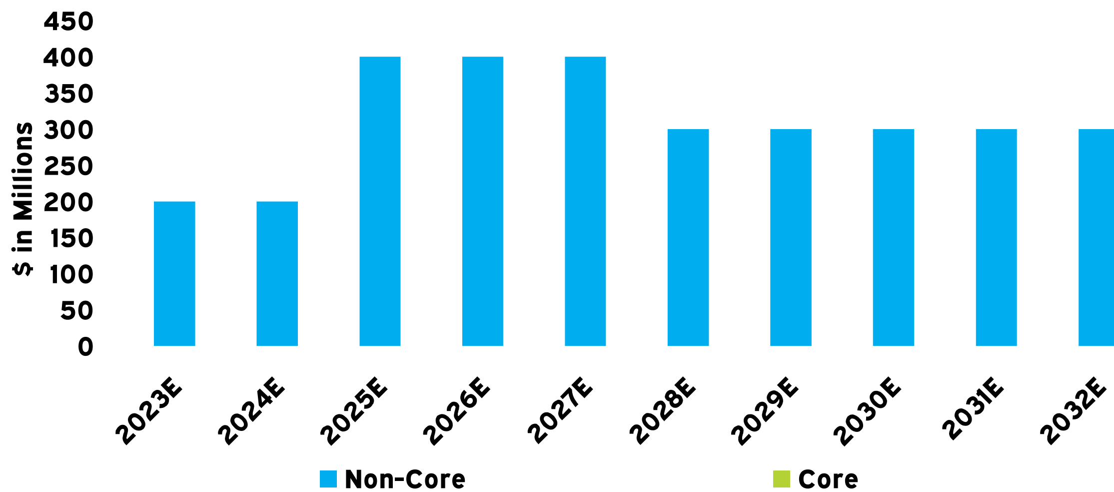


Exhibit 2 – TX ERS Fiscal Year 2023 Tactical Plan

FY 2023 Tactical Plan		
Category	**Number of Investments**	**New Commitments in $ Millions (Range)**
Core	0-1	$0 ($0-$100)
Non-Core	3-5	$200 ($0-$250)
TOTAL	**3-6**	**$200 ($100-$300)**

Given the role of private real estate within the context of the overall System's Portfolio, capital may be deployed across both core and non-core strategies.

Meketa highlights the following near-term investment dynamics that are likely to inform the TX ERS Staff's investment activities in Fiscal Year 2023:

1. CORE RETURNS WERE RECORD SETTING DURING CALENDAR 2021, with the ODCE index recording a net 21% return for the year. ODCE funds employ third parties to determine their assets' values. There was significant disparity within returns based on property type and location. Weaker hospitality, retail and office performance was offset by very strong increases in capital values among industrial, storage, data centers and multifamily properties. Indeed, the industrial sector posted a one-year return of over 40% in 2021. As an effect of the pandemic, the largest city centers continued to lag smaller cities that typically rely less on public transportation, and suburban locations generally. Valuations were supported by remarkable rent growth in many sectors as well as the amount of capital seeking cash flows collateralized by hard assets.
2. Non-core risk investments in closed end funds, which deliver the bulk of their returns from capital appreciation and sales proceeds, and whose interim valuations are determined by their sponsors, experienced different results depending on their underlying property type mix. The use of significant amounts of third party leverage amplifies performance in both directions compared to core returns.
3. Industrial assets are deeply embedded in the dynamic growth trajectory driven by increasing e-commerce and the associated last-mile delivery of goods, as well as onshoring of manufacturing. Multifamily continues to perform strongly because of the general housing shortage and ownership affordability factors, as does most every kind of residential. Significant capital was committed and invested in single family rentals,

both in distinct, newly build communities and existing, scattered sites portfolios. Retail is a mixed bag, with some properties proving to be both pandemic and internet resilient, while others struggle with the clicks-vs-bricks dynamic, exacerbated by COVID restrictions. Future performance within the office sector is the most murky, hampered by the slow return to the office and uncertainty surrounding how hybrid working will impact demand for space. Suburban office properties appear to be faring somewhat better than big-city, public-transit dependent downtowns. Expectations are that office demand will remain fragmented while companies figure out what their "new normal" looks like.

All but the newest office properties are also contending with potentially significant capital expenditure requirements to enhance the safety and wellness of the property, the ESG profiles of the building, and to offer the modern spaces and amenities that tenants desire today.

4. There is an equally interesting dispersion of returns across different geographies, with markets in the "smile" states (generally characterized by lower densities, higher employment growth, lower taxes, lower cost of living, nicer weather) outperforming some of the denser coastal gateway markets.

5. Transaction volumes paused during Q2-3 2020 before returning to very strong levels in 2021. While managers expected distress to materialize, it didn't. Surprisingly strong rent collections, healthier balance sheets, the low interest rate environment and banks' willingness to provide forbearance all worked to keep tenants and owners in place. The weight of capital wanting to access hard assets and their cash flows quickly created pricing floors.

6. Institutional capital continued to flow into the property markets, buoying prices for nearly all assets. With low interest rates, and accessible mortgage financing, capital continued to rotate out of fixed-income assets and into commercial real estate. However, recent increases to interest rates have caused some deals to be re-traded or fall through. There is also anecdotal evidence of a 5-10% decline in pricing from peak levels earlier this year. Investors continued to look for alternatives to achieve favorable risk-adjusted returns as capitalization rates continued to compress across many asset classes, including industrial, multifamily and newly built single family rental housing. Capital is increasingly flowing into alternative property types (self storage, medical office, manufactured housing, data centers, production studios, single family rentals) compressing cap rates and narrowing the "premium" for other than the traditional property types. Whether the

pace of deployment will continue to be as torrential with the onset of a higher rate environment or not remains to be seen. Highly leveraged buyers are less likely to compete as underwriting tightens. The committed, but uncalled, mountains of capital are still looming large. Almost no general partner of our acquaintance ever cancels or refunds LP commitments, so, there will be acquisitions.

7. During 2019-2021, many plans increased allocations to real estate, as the rise in stock market values and the paucity of fixed income returns translated to underweighting in real estate relative to their previous target allocations. Challenges to increasing actual allocation include market conditions (pricing), the resources required for underwriting, the pace of distributions, among others. Now, with the setback in global equity values, and slightly more attractive fixed income (and increased private debt opportunities offered), real estate portfolio levels are closer to the target allocation percentages.

8. After the tremendous run up in rent growth in 2021, not surprisingly investors are finding it harder to justify asking prices on some assets. Investors are spending more time understanding pro forma rents, growth rates, increasing financing costs and the capital expenditures that will be required during the expected hold period of the asset to maintain its relevancy and attractiveness to tenants, as well as the next buyer.

9. Some non-core general partners are seeing the changes in 2022 as harbingers of opportunities to acquire assets at very favorable prices. This may be the case; however, these opportunities are historically available when there is widespread distress in property markets, or changes in regulatory requirements arise. This is not currently the case. While the possibility of recession during 2022-23 is higher than was expected a year ago, and if it occurs there will be distressed lenders and owns who are obligated to transact, this does not appear large in the current landscape.

10. MAINTAIN FOCUS ON EFFECTIVE EXECUTION AND PORTFOLIO MANAGEMENT. Staff should use its well-established relationships with strong partners to (i) closely monitor existing portfolios and key investment professionals, (ii) assess emerging opportunities to co-invest and/or otherwise deploy capital opportunistically, and (iii) continue to use its scale and status as a reliable, oftentimes lead, investor, to effect lower fees and preferred operating terms with general partners compared to smaller institutions.

Introduction

This memo serves as the Private Real Estate Portfolio Annual Tactical Plan for the fiscal year ending 8/31/2023. Meketa creates this Plan as a guiding reference only, and it is not intended to overrule prudent real estate investment decision-making, particularly in periods of extreme market volatility. Real estate and capital market conditions will be very fluid and dynamic during the remainder of this fiscal year ending 8/31/2022, and revisions to this 2023 Plan may be warranted when additional data becomes available.

By Policy, the objectives of the System's Real Estate Portfolio include:

1. Preserving the System's capital;
2. Enhancing the System's Total Portfolio risk-adjusted returns;
3. Further diversifying the System's Total Portfolio;
4. Reducing the System's Total Portfolio volatility; and
5. Providing a hedge against inflation.

The primary risk controls of the Private Real Estate Portfolio include the annual capital pacing plan ("Pacing Plan"), regional diversification, strategy diversification, property type diversification and leverage considerations. As of March 31, 2022, the market value of the Private Real Estate Portfolio equaled approximately $3.7 billion or 10.5% of the System's assets, which is above long-term target of 9% as specified in Exhibit 3.

Exhibit 3 – TX ERS Target Allocation

Asset Class Allocation	Long-Term Target	Min	Max	In Compliance
Private Real Estate	9%	4%	14%	Yes

The total economic exposure of the Portfolio, which includes (i) the market value plus (ii) the currently committed yet uncalled capital of $1.6 billion, is approximately $5.3 billion or approximately 15.2% of the System's assets. Meketa believes this is appropriate. As with other private market asset classes, the ability to precisely time the actual investment of previously committed private real estate capital is difficult. To deploy at the target percentage levels, there is often a need to "over" commit capital, primarily due to timing as managers draw the capital during respective three- to four-year acquisition periods. In addition, the return of capital from investment distributions is also unpredictable; however, given the increased demand for finished and substantially finished Value Add risk assets, Meketa

believes that the pace of sales and distributions back to limited partners may well be accelerated compared to prior periods. This is more likely as almost all real estate profit participations are calculated against an IRR threshold. The shorter the duration of the hold period, the more likely the IRR is elevated.. Thus, Meketa does not see the current difference between actual NAV as a percentage of assets, versus targeted percentage, as a concern. The real estate program has achieved many milestones in support of its role within the overall TX ERS portfolio. It has committed and deployed capital at a strong and steady pace to reach its target allocation. It is currently well diversified by strategy (including core and non-core levels of risk and return), manager, property type and geography. The Portfolio metrics are all within program policy guidelines. Investments have been made on a relatively cost-effective basis compared to market investment management rates, in part due to scale, Staff's existing relationships and willingness to invest earlier in the capital formation process than other investors. Also, by participating in "club funds" and co-investments, Staff has negotiated favorable terms. While many investments remained unrealized, the performance of the Portfolio is meeting expected risk adjusted return expectations and exceeding its benchmark.

The Pacing Plan is prepared as part of the Annual Tactical Plan. It presents potential ranges for both the core and non-core real estate commitment activity required to meet the target allocation during the next five years. With the Portfolio above its long-term target allocation of 9%, Staff is not under undue pressure to continue to commit capital into today's uncertain market. Indeed, Staff has the ability to gather additional market data as it becomes available and build conviction around timing and best ideas as the next fiscal year plays out.

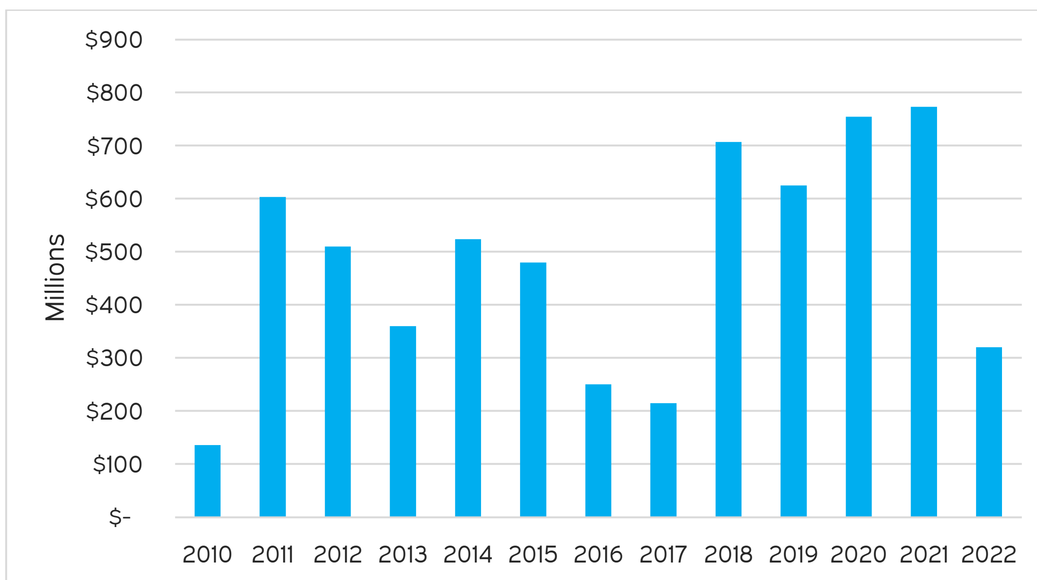
As of March 31, 2022, equity or debt investments in real estate technology and services ("Prop Tech") are included as part of the Non-Core Private Real Estate allocation and represents less than 1% of the private real estate portfolio.

Portfolio Snapshot

The Private Real Estate Program was initiated in fiscal year 2008. Since then, the System has made 100 commitments, totaling over $6.0 billion, to open-end funds, closed-end funds, separate accounts and co-investments, through more than 40 third-party managers, as seen in Exhibit 4. The System does not manage private real estate directly but employs a variety of structures in order to enhance returns, maximize efficiency of resources, achieve diversification and manage risk.

Exhibit 4 – TX ERS Commitment Amounts by Fiscal Year

Fiscal Year End August 31



Note: Commitments for FY 2022 through June 2022.

In May 2021, the TX ERS Board of Trustees approved the Tactical Plan for FY 2022, which included a target of $350 million in new capital commitments with an upper limit of $700 million, split evenly between core and non-core strategies. As shown in the table below, as of June 30, 2022, the System has committed a total of $320 million, $200 million committed to three core/core plus funds and $120 million to six non-core deals four of which were co-investments. Exhibit 5 details these commitments. Recent commitments to technology oriented real estate services (data centers) and life sciences strategies have added to the System's stable of resilient real estate portfolios. As seen in Exhibit 6, currently the Portfolio is within risk policy guidelines, although continued attention will be needed to maintain policy compliance across risk buckets.

Exhibit 5 – Fiscal Year 2022 Commitments

Commitments since September 1, 2021

Fund	Risk Category	Commitment
AEW Essential Housing Fund	Core	$50,000,000
Blue Vista City Select Fund	Core	$50,000,000
Wheelock Long Term Value Fund	Core	$100,000,000
Meridian Special Opportunities Co-Investment Fund	Non-Core	$25,000,000
Oak Street Seedling Capital Fund III	Non-Core	$25,000,000
PAG Real Estate Partners III	Non-Core	$50,000,000
PAG Real Estate Partners III Co-Investment	Non-Core	$10,000,000
SCREP VII Co-Investment (2 deals)	Non-Core	$10,000,000
TOTAL		**$320,000,000**

Exhibit 6- Portfolio in Compliance

Private Real Estate Asset Category	Risk/ Return Strategy Allocation	Allocation as of March 31, 2022	In Compliance
Core	35% +/- 15%	33%	Yes
Non-Core	65% +/- 15%	67%	Yes

The program is diversified by risk profile, investment manager, property type and geography. New investments should continue to enhance the portfolio construction but also can be more tactical and take advantage of more specific opportunities as they present themselves to complement existing holdings.

Performance and Benchmark

The TX ERS real estate program contributed a strong net total return of 12.9% over the trailing five years as of March 31, 2022. The Portfolio continued to benefit from solid partnership and strategy selections many of which proved particularly resilient during COVID, increased demand for current yield in the face of insufficient fixed income returns and lower than historic new supply. Per Exhibit 7 below, the System's real estate Portfolio has posted strong performance both gross and net of fees across all time periods, on both an absolute basis and relative to the System's benchmark, outperforming on a net basis the NFI-ODCE by approximately 400 basis points over the trailing five-year period and 230 basis points since inception.

Exhibit 7 – Time Weighted Returns as of March 31, 2022

Time Weighted Gross Total Returns as of March 31, 2022	1 Year	3 Years	5 Years	Since Inception	Inception Date
Core Composite – Gross	34.0	16.5	14.3	13.8	07/01/2010
Non-Core Composite – Gross	35.8	17.3	17.1	19.3	06/30/2011
Texas ERS Total Plan Composite - Gross	35.3	17.2	16.3	16.1	07/01/2010
NCREIF Fund Index-ODCE (VW) (Gross)	28.5	11.3	9.9	11.8	07/01/2010
Over/Under Performance	**6.8**	**5.9**	**6.4**	**4.3**	

Time Weighted Net Total Returns as of March 31, 2022	1 Year	3 Years	5 Years	Since Inception	Inception Date
Core Composite – Net	29.0	14.2	12.3	12.1	07/01/2010
Non-Core Composite – Net	28.4	13.4	13.1	13.3	06/30/2011
Texas ERS Total Plan Composite - Net	28.6	13.8	12.9	13.1	07/01/2010
NCREIF Fund Index-ODCE (VW) (Net)	27.3	10.3	8.9	10.8	07/01/2010
Over/Under Performance	**1.3**	**3.5**	**4.0**	**2.3**	

TX ERS Staff has been able to accomplish significant progress towards growing and rebalancing the System's real estate portfolio to approach the long-term 9% target allocation in FY 2022. The strong performance of the private real estate portfolio the past three quarters and decrease in public market performance during the first few months of 2022 has caused the private real estate portfolio allocation to increase in excess of the 9% target allocation.

Pacing Plan Analysis

The annual Pacing Plan is a tool to help the System update its estimate of the annual investment volume needed to meet target allocations. The Pacing Plan is a model based on assumptions and estimates and should be used as a guide rather than a directive. To prepare the Pacing Plan, data is collected on the Portfolio from the System's managers, both those to whom the System has funded capital and those to whom the System has committed, but who have not yet drawn capital. Meketa aggregates these to see a range of what may remain for Staff in a "budget" for new commitments during the next several years. Exhibits 8 and 9 present the estimated cash flows for the System and the commitments needed over the next ten years to approach the target allocation. Input from Staff informs the relative size of the annual commitments within the ten-year Pacing Plan window. The "budget" also gives consideration to the number of relationships which can be managed by Staff resources and tries to show conviction with larger commitments to proven partners when possible while avoiding unnecessarily high levels of concentration.

The caveats to the Pacing Plan include, but are not limited to, the number and size of transactions that the managers can acquire; the required capital necessary to execute the individual assets' business plans; the appetite for the purchase of the managers' finished product to effect a "round trip" exit; changes in capital market and property market conditions which change the timing of deployment and return of capital; whether the manager requires extensions of the acquisition period or the disposition period and other factors. Thus, the tool is not intended to be and should not be relied on for any specific quarter's or year's cash flow projections. Note that while remaining close to the target percentage amounts of investments, the portfolio is projected to be net cash flow positive for all 10 years.

Exhibit 8 – Projected Total Cash Flows

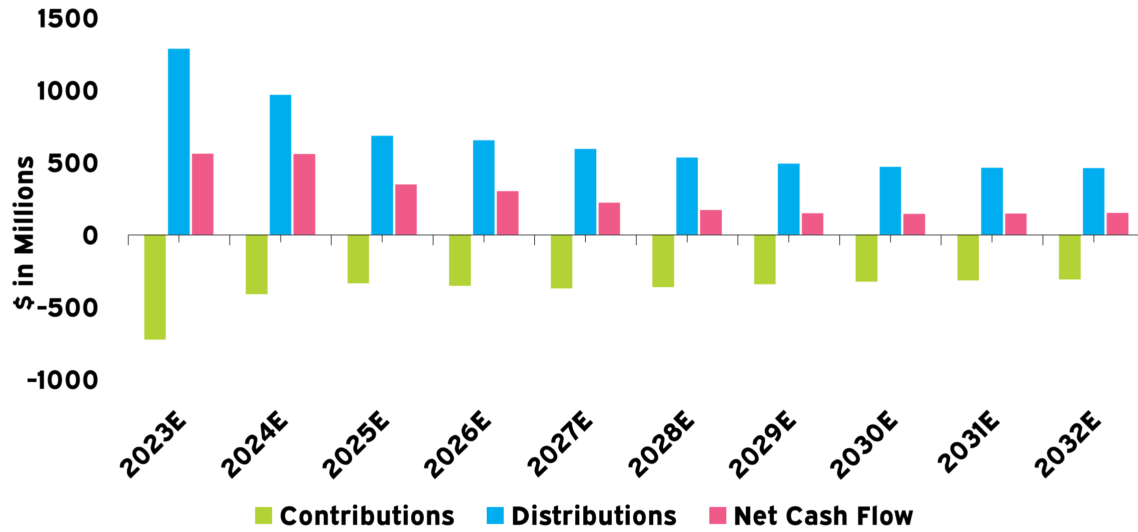


Exhibit 9- Commitment Schedule

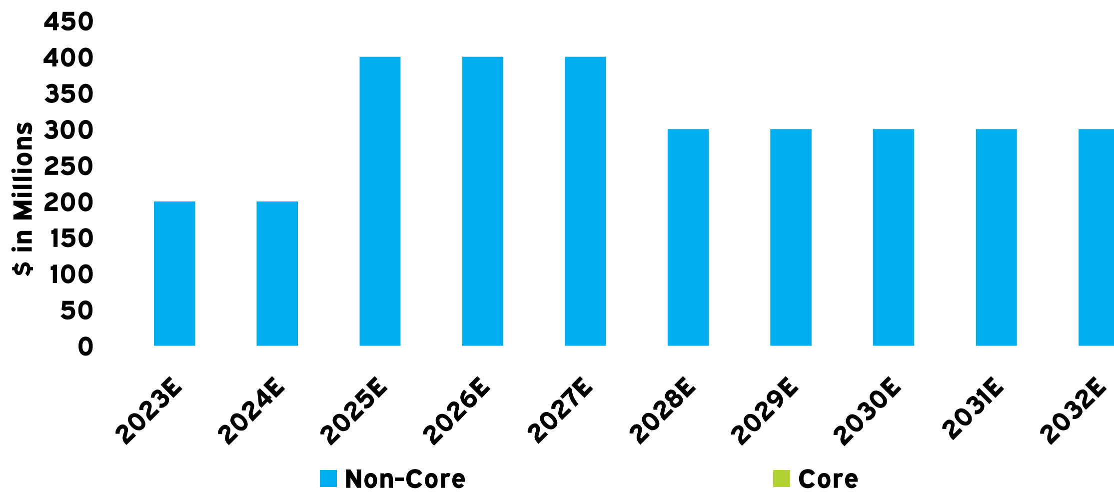
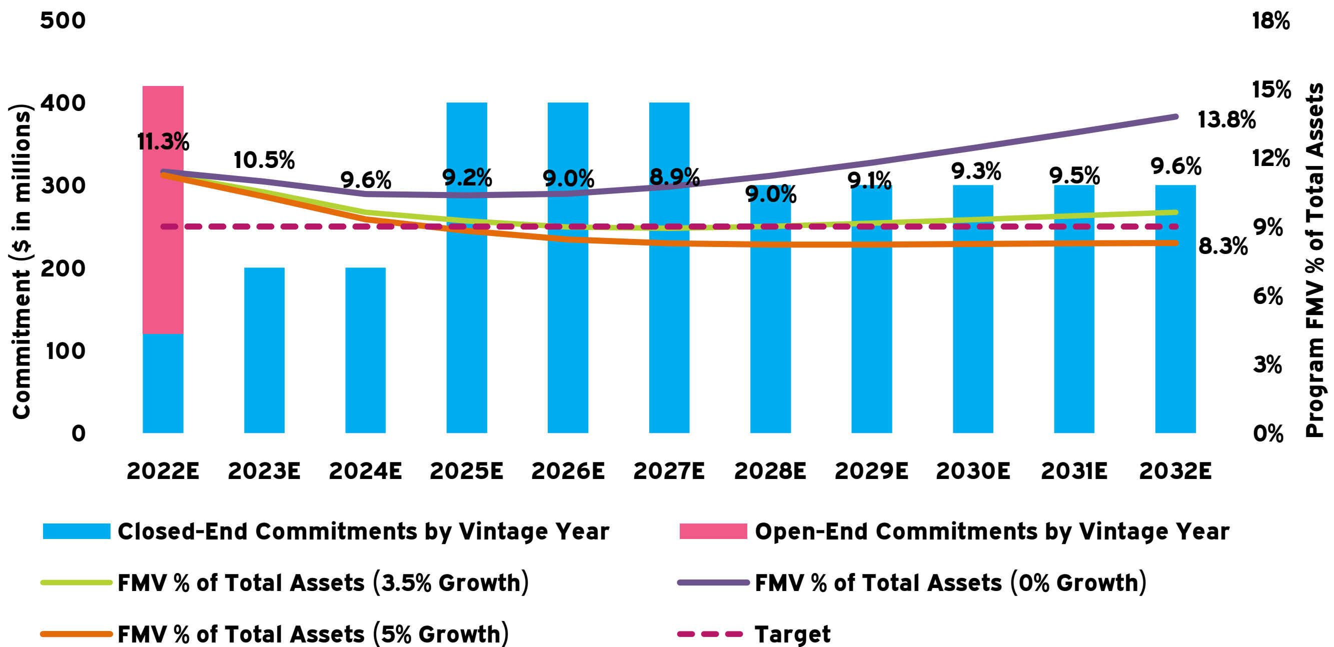


Exhibit 11 – TX ERS Fiscal Year 2023 Pacing Plan

FY 2023 Pacing Plan		
Category	**Number of Investments**	**New Commitments in $ Millions (Range)**
Core	0-1	$0 ($0-$100)
Non-Core	3-5	$200 ($0-$250)
TOTAL	**3-6**	**$200 ($100-$300)**

Meketa expects continued uncertainty in the markets during the next 12-24 months. This compounds the need for flexibility and ranges around total new commitments for FY 2023 and beyond, as the value of the private real estate Portfolio and of the total Portfolio experience historic year-to-year fluctuations.

The following Exhibit 12 displays a sensitivity analysis around the expected real estate allocation relative to total plan growth rates. The purpose of this Exhibit is to demonstrate the projected real estate weight relative to the System's assets assuming no changes to real estate commitments or cash flows. However, Staff would adjust course (increasing or decreasing commitments) based on changes to the System's total returns and in response to changing market opportunities and concerns.



Real Estate Market Outlook and Investment Implications

While real estate performance surprised to the upside in 2021 as a result of both cap rate compression and impressive rent growth, we expect lingering effects of the pandemic on the operation of and valuation of commercial real estate. Rising inflation is also a question mark as to magnitude, duration, and impact on commercial real estate pricing and transaction volumes.

In addition to the threat, horror and humanitarian crisis wrought by Putin's invasion of the Ukraine, the chaos is a most dangerous wild card insofar as investing is concerned. Continued close scrutiny reveals previously unconsidered risks. Beyond the disruption to energy prices in the short term, many market segments (and in the case of most institutional investors, the most important one, shares listed on the United States' stock exchanges), surprisingly held their valuations through the end of 2021 before decreasing in the first few months of 2022.

Private real estate cannot be relocated to avoid changes in use, pandemics, interruptions in supply chains, short term energy price shocks and political gridlock. The one thing we can say with certainty about our predictions of the future trends and results in property investing is that many of them will likely be wrong—as to timing, pricing and effect. Having said that, there is still good reason to continue to hew the path set out for us—prudent, risk-adjusted, downside protected investment in new groups of assets with fiduciaries whose interests are well aligned with TX ERS and using the resources of Staff and Consultant to monitor and test the decisions.

There will be opportunities to pursue. Staff is keenly seeking and investigating them. The long-term nature of the asset class will reward those with patient and disciplined capital. But it may not reward them just quite yet!

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