MEKETA | 45
CELEBRATING A MILESTONE | YEARS

2175 NW Raleigh Street
Suite 300A
Portland, OR 97210

503.226.1050
Meketa.com

MEMORANDUM

TO: Board of Trustees – Employees Retirement System of Texas
FROM: Meketa Investment Group ("Meketa")
DATE: May 2023
RE: Private Real Estate Portfolio Market and Performance Overview

Preface

In our role as the Real Estate Consultant, Meketa Investment Group ("Meketa") prepared a Portfolio Overview covering current market conditions, Portfolio performance and information on key policy parameters as of December 31, 2022.

While the core NCREIF ODCE Fund universe produced historically high returns in 2021 and the first part of 2022, steeply rising inflation, and the corresponding monetary policy actions of the Federal Reserve have had a widespread and negative impact on commercial real estate. The collapse of Silicon Valley Bank and Signature Bank, coupled with the cash infusion in First Republic Bank, to-date in 2023, has caused further economic uncertainty and volatility in the banking industry and capital markets which is also impacting commercial real estate.

Inflation continues to be a material market phenomenon. While "hard assets" such as real estate offer protection from inflation over the mid to longer term because of their ability to raise rents, the timing and amount of correlation vary depending on the individual rent roll (weighted average lease terms), market supply and demand for competing space (also affected by changing usage needs), legislation, and other factors. As 2022 progressed, rent growth slowed dramatically across property types and locations, but overall fundamentals, such as occupancy, remained healthy. Rising inflation is driving dramatically increased debt costs, which is particularly pertinent to the capital intensive private real estate industry. Debt costs for all types of commercial real estate have nearly doubled in the past year, and for the first time in more than a decade, market conditions are resulting in "negative" or non-accretive leverage, meaning the cost of new debt financing exceeds the going-in yield of the real estate acquisition.

As the overall economy slows and the prospects of the US entering a recession in 2023 seem more likely, we expect rent growth and property values to continue to decline. The actions of the Federal Reserve aimed at lowering inflation have resulted in near frozen debt capital markets, greatly reduced transaction volume, and price opacity.

Even though many properties experienced full recoveries during 2021 and into 2022, and in some cases have exceeded pre-pandemic levels, the dispersion of returns varied greatly by market and property type. Different locations and property types' experience will continue to vary considerably, even in the same generally accepted statistical metro areas. Individual real estate assets' performance will continue to vary based on things such as: changing space utilization patterns, technology, levels of home renter-ship, an aging population, e-commerce utilization, and employment levels and trends.

Even though there remains material uncertainty across almost all geographic real estate markets during the next 12-24 months, the role of private real estate is clear within the overall Employees Retirement System of Texas ("TX ERS" or "the System") portfolio construction. The System has the ability to take risks when and where the

returns warrant. 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. Staff has also tried to limit the number of investments which use a high amount of leverage and the Portfolio currently stands at approximately 50% leverage, which is relatively conservative. Finally, despite the turmoil of the past three years, Staff has continued to steadfastly focus and execute the construction of the portfolio and retain the team and its productivity.

Summary

Meketa highlights the following near-term investment dynamics that are likely to inform the TX ERS Staff's investment activities for the remainder of Fiscal Year 2023 and into Fiscal Year 2024:

1. Interest rate hikes instituted by the Federal Reserve in order to lower decades high inflation have caused significant volatility in the capital markets. Debt costs which have more than doubled, coupled with slowing rent growth, compared to the outsized growth experienced in 2021 and the first half of 2022, have had a significant and negative impact on commercial real estate property values.
2. Rising interest rates have also been the impetus for two high profile regional bank failures which induced turmoil and a great deal of uncertainty across the banking industry. It is widely anticipated that lenders will become more conservative with their underwriting and willingness to make loans.
3. Inflation continues to be a material market phenomenon. While "hard assets" such as real estate offer protection from inflation over the mid to longer term because of their ability to raise rents, the timing and amount of correlation vary depending on the individual rent roll (weighted average lease terms), market supply and demand for competing space (also affected by changing usage needs), legislation (especially around net zero carbon initiatives and multifamily rent regulation), and other factors.
4. For the first time in more than a decade, market conditions are resulting in "negative" or non-accretive leverage, meaning the cost of new debt financing exceeds the going-in yield of the real estate acquisition. As interest rates have been rising there has been an increase in the number of deals that have fallen through or been re-priced.
5. Transaction volumes returned to very strong levels in 2021 and the first half of 2022. However, the current volatility in the capital markets and overall economic uncertainty have resulted in near frozen debt capital markets and greatly reduced transaction volumes. The thin transaction volume is creating a challenging valuation and price discovery environment.
6. Those with upcoming loan maturities, expiring interest rate caps, and other situations requiring a re-financing of current debt could have difficulty obtaining financing and be forced to sell their commercial real estate asset(s). Those holding office, hotel and retail property types will have more difficulty getting new financing than those holding industrial and/or multifamily assets. While this situation could create buying opportunities for well capitalized, low leverage investors, the current economic uncertainty coupled with thin transaction volumes (and therefore comparable sales) makes finding reasonable price and return expectations challenging.
7. Core returns were record setting during calendar 2021 and the first half of 2022, with the ODCE index recording a net 21% return for calendar year 2021 and a net one-year return of 28.3% as of June 30, 2022. However, the second half of 2022 saw flat to negative returns with the 2022 calendar year ending with a net 6.5% one-year return. ODCE funds employ third parties to determine their assets' values. There has been significant disparity within returns based on property type and location. Furthermore, public market real estate securities were down approximately 25% (as represented by the FTSE EPRA/NAREIT index) for calendar year 2022, but the public markets always lead the private

markets. Consequently, private real estate will most likely continue to see further write downs but possibly not to the same magnitude as the public markets since they tend to over or under shoot.

8. Weaker hospitality, retail and office performance is being offset by increases in capital values among industrial, multifamily, data centers, and life science properties. 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 and other for-rent residential continues to have a steady stream of renters and healthy occupancy levels due to the general housing shortage and ownership affordability factors. A cloud-computing and technology reliant population, is driving investments in datacenters and an aging population is driving investments in life science and medical office assets. Retail is a mixed bag, with some properties proving to be both pandemic and internet resilient, while others struggle to compete with e-commerce and attract customers for reasons beyond non-grocery and necessity shopping. Future performance within the office sector is the most murky, hampered by the uncertainty surrounding how hybrid working will impact demand for space. Suburban office properties are faring better than properties in big-city, central business districts, and all but the newest office properties are contending with potentially significant capital expenditure requirements to enhance the safety and wellness of the property, and to offer the modern spaces and amenities that tenants desire today. Office valuations overall have noticeably decreased over the past three years and many expect values to decline further.

9. There is a dispersion of returns across geographies. As an effect of the pandemic, the largest city centers and denser, gateway coastal markets continue to lag smaller cities and some suburban locations.. The Sunbelt states have seen noticeable increases in population due to nicer weather, typically a lower cost of living, better quality of life, and availability of high quality jobs.

10. Over the past few years, institutional, private investors began looking beyond traditional property types to find attractive and resilient income streams in alternative property types such as self storage, medical office, manufactured housing, data centers, productions studios, and single family rentals.

11. Highly leveraged buyers are less likely to compete as underwriting tightens. The committed but uncalled mountains of capital are still looming large, although the amount raised for new closed-end funds decreased throughout 2022 and to-date in 2023. Investors are becoming more selective when committing to additional funds.

12. Allocations to private real estate have steadily increased over the last decade and now average 10.8%. Allocations rose quickly following the sharp decrease in global equity values during 2022. Strong portfolio returns combined with the denominator effect contributed to overallocations in institutional portfolios toward the end of 2022, but lower commercial real estate property values in the fourth quarter and into the new year are moving real estate portfolio levels closer to target allocation percentages again.

13. Some non-core general partners are seeing the changes to-date in 2023 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 when changes in regulatory requirements arise. Interest rate increases and the overall current economic environment is increasing the likelihood of pocketed distress and the recent regional bank collapses are leading to tighter lending standards. However, the quantum of distressed assets that may come to market is currently very unclear. If there is an increase in distressed properties coming to market, and there are distressed lenders or owners who are obligated to transact, it does not guarantee great buying opportunities as the underlying property types are likely to be dominated by out-of-favor office and hospitality assets.

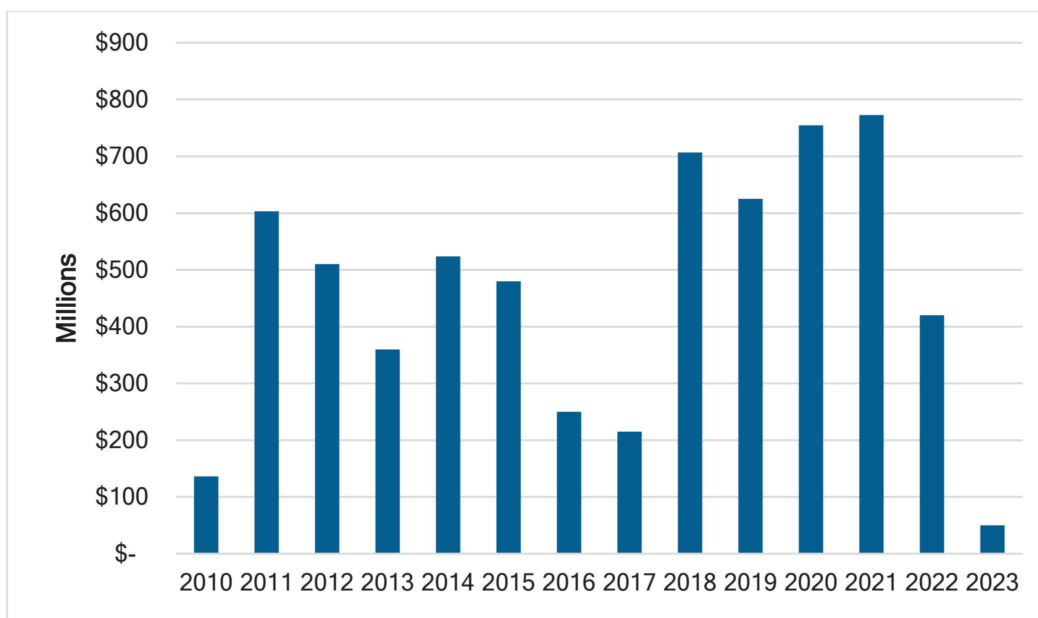
14. It remains critical to maintain focus on effective execution and portfolio management. Staff should use its well-established relationships with strong partners to (i) closely monitor existing portfolios and key investment professionals, (ii) assess emerging opportunities to co-invest and/or otherwise 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.

Portfolio Snapshot

The Private Real Estate Program was initiated in fiscal year 2008. Since then, the System has made 101 commitments, totaling over $6.4 billion, to open-end funds, closed-end funds, separate accounts and co-investments, through more than 40 third-party managers, as seen in Exhibit 1. 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 1 – TX ERS Commitment Amounts by Fiscal Year

Fiscal Year End August 31



Note: Commitments for FY 2023 through December 2022.

In August 2022, the TX ERS Board of Trustees approved the Tactical Plan for FY 2023, which included a target of $200 million in new capital commitments with an upper limit of $300 million, primarily directed at non-core strategies. As shown in Exhibit 2, as of December 31, 2022, the System has committed a total of $50 million, in one non-core strategy. The Portfolio is within risk policy guidelines, as shown in Exhibit 3, although continued attention will be needed to maintain policy compliance across risk buckets.

Exhibit 2 – Fiscal Year 2023 Commitments

Commitments since September 1, 2022

Fund	Risk Category	Commitment
Abacus Multi-family Partners VI, LP	Non-Core	$50,000,000
TOTAL		**$50,000,000**

Exhibit 3- Portfolio in Compliance

Private Real Estate Asset Category	Risk/ Return Strategy Allocation	Allocation as of December 31, 2022	In Compliance
Core	35% +/- 15%	32.5%	Yes
Non-Core	65% +/- 15%	67.5%	Yes

The program, which has a net asset value of $3,766.5 billion as of December 31, 2022 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 10.6% over the trailing five years as of December 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. It should also be noted that the current net total return over the trailing one-year period of 6.0% is significantly lower than the 26.2% trailing one-year return in the prior calendar year. Per Exhibit 4 below, the System's real estate Portfolio has posted strong performance both gross and net of fees across the longer dated three-year, five-year and since inception time periods, on both an absolute basis and relative to the System's benchmark, outperforming on a net basis the NFI-ODCE by approximately 290 basis points over the trailing five-year period and 220 basis points since inception.

Exhibit 4 – Time Weighted Returns as of December 31, 2022

Time Weighted Gross Total Returns as of December 31, 2022	1 Year	3 Years	5 Years	Since Inception	Inception Date
Core Composite – Gross	7.0	13.2	12.1	12.9	07/01/2010
Non-Core Composite – Gross	7.8	14.2	14.1	18.2	06/30/2011
Texas ERS Total Plan Composite - Gross	7.5	14.0	13.5	15.2	07/01/2010
NCREIF Fund Index-ODCE (VW) (Gross)	7.5	9.9	8.7	11.1	07/01/2010
Over/Under Performance	**0.0**	**4.1**	**4.8**	**4.1**	

Time Weighted Net Total Returns as of December 31, 2022	1 Year	3 Years	5 Years	Since Inception	Inception Date
Core Composite – Net	6.0	11.3	10.4	11.3	07/01/2010
Non-Core Composite – Net	6.0	11.0	10.7	12.5	06/30/2011
Texas ERS Total Plan Composite - Net	6.0	11.1	10.6	12.3	07/01/2010
NCREIF Fund Index-ODCE (VW) (Net)	6.5	9.0	7.7	10.1	07/01/2010
Over/Under Performance	**-0.5**	**2.1**	**2.9**	**2.2**	

TX ERS Staff has been able to accomplish significant progress towards growing and rebalancing the System's real estate portfolio. The strong performance of the private real estate portfolio over the past year and decrease in public market performance during 2022 has caused the private real estate portfolio allocation to increase to 11.4% of the total plan which is in excess of the 9% target allocation.

Real Estate Market Outlook and Investment Implications

While the core NCREIF ODCE Fund universe produced historically high returns in 2021 and the first part of 2022, decades-high inflation, and the corresponding monetary policy actions of the Federal Reserve have gradually had a widespread and negative impact on commercial real estate. Debt costs that have doubled, transaction volume at almost a halt due to near frozen debt capital markets, and declining rents are weighing heavy on commercial real estate values. The collapse of Silicon Valley Bank and Signature Bank, coupled with the cash infusion in First Republic Bank, to-date in 2023, has caused greater economic uncertainty and volatility in the banking industry and capital markets.

Investors are spending a lot more time assessing risks with their banking relationships and debt providers as well as trying to understand property valuations and the resilience (or vulnerability) of various demand drivers. Rent growth, increasing operating and financing costs, capital expenditures among other items, are having a cumulative effect on property values and expected returns. Valuations and related drivers can be further complicated by property type and geography as returns can vary dramatically based on investor appetite and underlying property fundamentals. It is anticipated that the dispersion of returns across property types and geographies will continue to result in clear winners and losers. As the overall economy slows and the prospects of the US entering a recession in 2023 seem more likely, we expect rent growth to continue to decline and values to decrease across property types and locations.

There remains significant dry powder equity capital (nearly $375 billion) raised and sitting on the sidelines ready to invest, although the amount raised for new closed-end funds decreased throughout 2022 and to-date in 2023. As institutional capital adapts to the re-pricing that is currently occurring in the private real estate market, investors are becoming more selective when committing to additional funds and preparing for an economic slowdown and uncertain commercial real estate environment.

Private real estate cannot be relocated to avoid changes in use, pandemics, capital market turmoil, interruptions in supply chains, 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 stay on the steady path that is prudent, risk-adjusted, downside protected investment with fiduciaries whose interests are well aligned with TX ERS and using the resources of Staff and Consultant to monitor and test the decisions.

Staff's continued discipline, long-term investment horizon in this illiquid asset class, and focus on the role of the asset class, particularly in times of market uncertainty and disruption, should continue to add diversification and serve the needs of the System.

DISCLOSURES: This document is provided for informational purposes only. It does not constitute an offer of securities of any of the issuers that may be described herein. Information contained herein may have been provided by third parties, including investment firms providing information on returns and assets under management, and may not have been independently verified. The past performance information contained in this report is not necessarily indicative of future results and there is no assurance that the investment in question will achieve comparable results or that the Firm will be able to implement its investment strategy or achieve its investment objectives. The actual realized value of currently unrealized investments (if any) will depend on a variety of factors, including future operating results, the value of the assets and market conditions at the time

of disposition, any related transaction costs and the timing and manner of sale, all of which may differ from the assumptions and circumstances on which any current unrealized valuations are based.

Neither Meketa Investment Group, Inc. ("Meketa" or the "Firm")) nor Meketa's officers, employees or agents, make any representation or warranty, express or implied, in relation to the accuracy or completeness of the information contained in this document or any oral information provided in connection herewith, or any data subsequently generated herefrom, and accept no responsibility, obligation or liability (whether direct or indirect, in contract, tort or otherwise) in relation to any of such information. Meketa and Meketa's officers, employees and agents expressly disclaim any and all liability that may be based on this document and any errors therein or omissions therefrom. Neither Meketa nor any of Meketa's officers, employees or agents, make any representation of warranty, express or implied, that any transaction has been or may be effected on the terms or in the manner stated in this document, or as to the achievement or reasonableness of future projections, management targets, estimates, prospects or returns, if any. Any views or terms contained herein are preliminary only, and are based on financial, economic, market and other conditions prevailing as of the date of this document and are therefore subject to change.

The information contained in this report may include forward-looking statements. Forward-looking statements include a number of risks, uncertainties and other factors beyond the control of the Firm, which may result in material differences in actual results, performance or other expectations. The opinions, estimates and analyses reflect Meketa's current judgment, which may change in the future.

Any tables, graphs or charts relating to past performance included in this report are intended only to illustrate investment performance for the historical periods shown. Such tables, graphs and charts are not intended to predict future performance and should not be used as the basis for an investment decision.

All trademarks or product names mentioned herein are the property of their respective owners. Indices are unmanaged and one cannot invest directly in an index. The index data provided is on an "as is" basis. In no event shall the index providers or its affiliates have any liability of any kind in connection with the index data or the portfolio described herein. Copying or redistributing the index data is strictly prohibited.