January 9, 2018

FROM: KATHLEEN RILEY BROWN, Assistant Retirement Administrator
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SUBJECT: ON-SITE DUE DILIGENCE REPORT ON HEITMAN AND MONROE CAPITAL

BACKGROUND

While in Chicago for an on-site due diligence visit with Northern Trust representatives in preparation for renegotiation of the renewal contract for Custodial bank services, Staff conducted extensive on-site due diligence visits with Heitman [REIT] on Monday, December 4th, and with Monroe Capital [Direct Lending] on Thursday, December 7, 2017, in accordance with the Joint Retirement Boards' Due Diligence Visitations Policy Statement Section 2-1B.

REITs

As background information, the Boards retained two REIT managers, Principal Global in Des Moines, Iowa and Heitman in Chicago, Illinois with an initial funding objective of up to two and one-half percent for each manager, in 2005, based upon the recommendation of its Investment Consultant [Wilshire] to add Public Real Estate investments via US Real Estate Investment Trust (REITs) to the Boards' Asset Allocation and Target Mix. The initial REIT implementation was accomplished by first funding Principal Global with funds withdrawn from JPMorgan Strategic Property Fund ($22.5 million) on January 5, 2005.

Due to the recommendation of REIT management firms, the consensus of Boards, Staff and Investment Consultant was that the Systems' should consider funding REITs over time rather than investing all at once given that REITs had previously had two very big performance years. Consequently, the Boards funded the Heitman REIT portfolio ($25.0 million withdrawn from JPM Strategic Property Fund) on July 5, 2005, six months after their initial investment with the Principal REIT portfolio. In January 2006, each REIT manager received an additional $10.0 million (funding from cash withdrawn from the Systems' large cap equity index fund); and in March 2007, the Boards' withdrew $8.0 million from Heitman and $8.5 million from Principal on recommendation from its Investment Consultant to reduce or eliminate REIT investments. These funds were used to fund monthly benefit payroll and operating expenses for two plus months.

In November of 2015, the Boards' approved the recommendation by Staff and NEPC to initiate an RFI (Request for Information) Value Add Real Estate Manager search. This search process culminated in June 2016, with the retention of two Value Add Real Estate managers, Oaktree Capital and PCCP both located in Los Angeles, California. At that time, the Boards adopted an asset allocation target of 1.2 percent or $30.0 million (a capital commitment of $15.0 million to each manager) to invest in value add real estate consistent with the NEPC Real Estate Plan adopted by the Boards in October 2015.

The Real Estate Plan is a strategic investment pacing plan to steadily reduce the REIT allocation to zero over a four-year period while concurrently investing in Value Add Real Estate to achieve the overall expected 4.0% allocation to Value Add Real Estate. It was anticipated that the Systems' would fund its value add real estate investments with approximately $30.0 million withdrawn annually from the Systems' REIT accounts [Heitman and Principal], subject to subsequent reviews. The initial withdrawal of $12.0 million came from Heitman in September 2016, and those funds were invested in the Systems' large cap equity index fund during the interim period pending capital calls from Oaktree and PCCP. Despite the slower than anticipated transition from REITs to Value Add Real Estate all real estate portfolios have performed well on a relative basis and the current total unfunded capital commitment for Value Add Real Estate is approximately ~$21.0 million.

NEPC will update the Boards with a 2018 Real Estate Plan recommendation in February 2018.

Direct Lending/Private Debt

In August 2015, following completion of an RFI Direct Lending manager search process, the Boards approved the recommendation to retain two direct lending managers, Monroe Capital Private Credit Fund II LP and Crescent Direct Lending Levered Fund, LP funds with an equal asset allocation of the 4% target (approximately $100 million or $50 million each), subject to legal counsel's review of side letter agreements. As of December 31, 2017, the total unfunded capital commitment for Direct Lending is approximately ~$16.5 million.

With an aim to maintain an adequate allocation to direct lending, Staff and NEPC recommended and the Boards approved the new 8% allocation to Private Debt/Direct Lending. One of the primary purposes of Direct Lending is to increase diversification and improve the overall risk of the total portfolio. A higher allocation to Direct Lending/Private Debt [from 4% to 8%] allows the Boards to consider additional new direct lending/private debt opportunities as they arise.

In April 2017, the Boards approved the Staff and NEPC recommendation to fund new direct lending opportunities with the Systems' current managers, Crescent and Monroe, approving additional capital commitments of $60.0 million to Crescent and $37.5 million to Monroe.

As a result of our recent meeting with Monroe, Staff has concerns about the effectiveness of the unequal capital commitment between Crescent and Monroe. In fact, given the additional information received about Monroe's process and current pipeline we believe that increasing the capital commitment to Monroe Capital Private Credit Fund III from $37.5 million to $60.0 million (equal to the allocation with Crescent) would be very appropriate and supports the initial intent to maintain an equal split between the two direct lending manager firms.

SUMMARY OF DUE DILIGENCE VISITS

The purpose of the on-site due diligence visits is to meet with all levels of management at the investment firms, to review criteria which affirms that the manager is in good standing and adheres to their stated philosophy, process and style, while also receiving more in depth updates and a detailed understanding of their trading, compliance, operations, and technology processes.

Heitman

Attendees: John Mancuso, Senior Vice President, Client Servicing and Marketing
Jerry Ehlinger, Managing Director, Senior Portfolio Manager
Mark Zahara, Senior Vice President, Head Trader
Mike Trench, Senior Vice President, Asset Management
Molly Nelson, Deputy Compliance Officer
William Pogorelec, Senior Vice President, Director of Operations
Michael Schick, Senior Vice President, Information Technology
Thomas McCarthy, Senior Managing Director, Private Real Estate Equity

Heitman is a global investment management firm that manages approximately $38 billion for clients in private and public real estate equity as well as private debt. As of December 31, 2017, Heitman manages approximately $61 million on behalf of the Retirement Systems, which is roughly two percent (2%) of the total fund. Heitman REIT portfolio has produced strong returns on a relative basis. However, since inception net returns have been inconsistent throughout their tenure. Due to prior periods of significant underperformance, CFRS negotiated and implemented a performance fee structure, effective July 1, 2010, to mitigate concerns over the lack of positive alpha. Heitman's investment process includes a detailed security analysis and selection process with weekly investment meetings where new investment ideas are discussed and vetted by fellow staff and senior management.

Heitman takes a proactive approach to compliance, technological enhancements, and cyber security threats and has a strong Code of Ethics orientation for employees. During routine advisory and fund exams, the SEC has found no discrepancies and only recommended improvements based on best practices for updating policies and procedures. Heitman reviews compliance matters seriously and the firm proactively prepares for routine audits with staff partnering with the SEC to understand new regulations and resolve any issues that might arise. The technology services team monitors all systems constantly to ensure no un-authorized attempts to breach security measures are successful. There is a disaster recovery site located in the western suburbs of Chicago. Tests are conducted periodically to ensure staff and systems can engage with the network in case of an unforeseen event.

Operationally, Heitman have a dedicated team where settlements and data integrity receive the utmost attention. Heitman distributes many reports on a monthly and quarterly basis that display how the fund is positioned, its performance and risk, and their perspectives on the markets.

Their trading process is methodical and research driven. Heitman has trading desks located around the world but the majority of staff is located in their Chicago headquarters. The two main components of the trading desk are value contributors and alpha generation. This is accomplished via communication, process, and execution. All trading is undertaken in the EZE order management system (OMS) and each trade must pass client guidelines before it is included in the portfolio. Cash management is reconciled to the custodian each morning and after the markets close, if trading occurred, to ensure no portfolios overspent during the day.

Monroe Capital

Meeting Attendees: Megan Cruse, Director, Marketing & Investor Relations
Taylor Eversden, Vice President, Investor Relations
Michael Egan, Executive Vice President, Chief Credit Officer
Thomas Aronson, Managing Director, Head of Originations
Karina Stahl, Managing Director, Finance & Operations
James Cassidy, Managing Director, Fund Compliance and Finance

Monroe Capital was founded in 2004, although founders have been working together for 18 years and their first institutional direct lending fund was launched in 2014 with $500M in commitments. Monroe manages approximately $5 billion in private credit solutions for clients across the US and Canada. Their specialty is in lower middle market lending to companies with EBITDA of less than $30 million. Monroe is defined by a “zero loss” mentality that is focused on credit structure, downside risk, and principal protection.

As of December 31, 2017, Monroe manages ~$49 million for the Retirement Systems in the Monroe Capital Private Credit Fund II; capital commitment $50.0 million and 85% of committed capital called as of September 30, 2017, and this investment represents ~1.7% of the Systems’ total fund. To date, Fund II has had over $4 million in distributions since inception; and Monroe has called 85% of the Systems’ capital commitment. Fund performance has been slightly better than expected due to their use of lines of credit versus capital calls although it is still somewhat too early to be meaningful. The net internal rate of return (IRR) since inception is 16.06%.

Monroe utilizes several vendors for a host of activities such as: cash management, trade entry, portfolio management, and portfolio reconciliation. As Monroe has grown and matured, technology has become a major area for enhancement. They are currently in the process of building a centralized multi-functional platform that can be used seamlessly between the front, middle, and back office teams.

In addition to the investment team, Monroe has experienced and dedicated staff that focuses on accounting and operational needs utilizing a hub-and-spoke approach. Their platform blends internal and external resources to maximize efficiency and reliability. The middle and back offices as the hub and areas such as: accounting, finance, treasury, loan operations, and compliance all feed in an efficient manner into the hub. These areas are vitally important to Monroe’s success to deliver an institutional quality platform and reliability.

Monroe takes compliance and cyber security issues seriously with routine checks and internal meetings. Valuation and allocation policies guide the Fund and Investment compliance functions. Monroe utilizes two valuation partners with valuations of 100% of the credits completed on a quarterly basis, 50% by each of the two firms. Monroe has a formal Business Continuity & Disaster Recovery Plan.

RECOMMENDATION

Heitman and Monroe are well-run financial investment management organizations. Staff believes the investment and operational aspects of both firms are appropriately managed from an internal perspective, and tested proactively from an external perspective.

Staff continues to support the NEPC Real Estate Plan ("funding or pacing plan") which calls for further Heitman draw down, as capital is called, for funding of other value add real estate opportunities. We would support additional search processes to facilitate the progress to strategically move investments toward value add real estate.

Additionally, Staff recommends the Boards consider increasing their initial commitment to Monroe Capital Private Credit Fund III (currently $37.5 million) to $60 million. The unfunded commitment to the initial funds with Crescent and Monroe are $8.993 million and $7.5 million, respectively. Capital has been called equally efficiently by both firms, committing only $37.5 million to Monroe while committing $60.0 million to Crescent may not effectively source the Systems' investments in direct lending. Monroe expects the next onshore close for Fund III to be the third week of January and final onshore close in Q2 2018. If the Boards approve this recommendation to increase the capital commitment to Monroe Capital Private Credit Fund III, Staff will notify Monroe of the Boards decision immediately.