



# Board of Retirement Regular Meeting

## Sacramento County Employees' Retirement System

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### Agenda Item 18

**MEETING DATE:** October 16, 2019

**SUBJECT:** Private Equity Co-Investment Structure

**SUBMITTED FOR:**  Consent  **Deliberation** and Action  **Receive** and File

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### RECOMMENDATION

Staff recommends the Board receive and file the presentation related to an investment structure for making co-investments within the private equity asset class.

### PURPOSE

This agenda item supports the 2019-20 Strategic Management Plan initiative of developing and implementing a co-investment protocol.

### SUMMARY

Over the last 20 years, private equity buyout funds have delivered exceptional net returns for investors. The since inception IRR of the direct buyout funds in the SCERS portfolio, for example, has returned 21.7% as of June 2019 compared to the Russell 3000 which has returned 11.9%. Staff and Cliffwater's efforts over the last 10 years has resulted in a portfolio of robust and high-performing buyout General Partner (GP) relationships where Staff anticipates having long-term relationships spanning multiple funds. Staff expects to continue to invest as a Limited Partner (LP) with existing managers, but is also seeking new managers to complement the existing portfolio while being mindful of manager proliferation. Staff and Cliffwater have worked to develop a plan allowing SCERS to invest more capital with higher conviction managers while being cognizant of the impact that fees and expenses can have on net performance.

Co-investments are identified and included within SCERS' asset category investment policy statements (IPs) including the Growth Category IPS. Staff envisions a co-investment structure within the Private Equity asset class of up to \$100 million, implemented over a multi-year period, with a flexible approach to pacing depending on deal flow. Any manager recommendation would be presented separately according to the implementation protocol section of the asset category IPs.

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## **BACKGROUND**

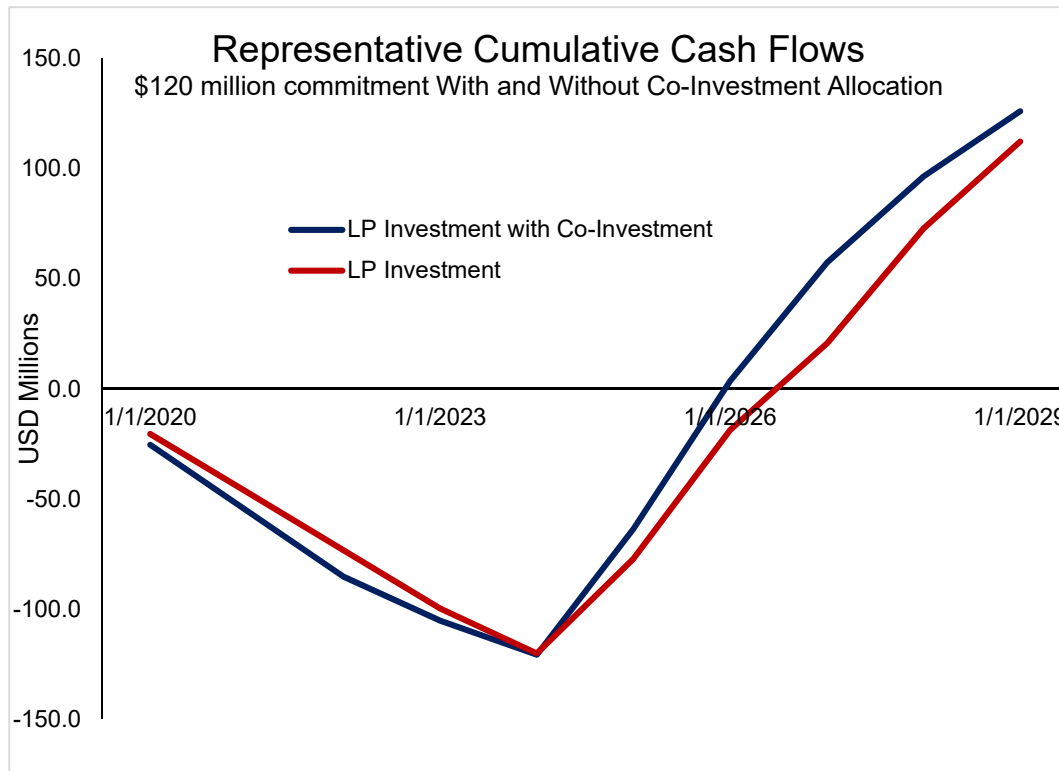
A co-investment is an investment alongside a GP into a company directly, often without paying manager fees, carried interest, or expenses. GPs look to bring co-investors into transactions for a variety of reasons including:

- A deal is too large for the fund itself.
- The manager does not want to concentrate the fund on a single portfolio company.
- A transaction structure needs increased flexibility on the balance sheet, which may result in future capital needs.
- A good co-investment strengthens the LP/GP relationship and allows the GP to cultivate strong relationships with a core group of LPs.

An objective of co-investments is to earn higher returns than that of primary fund investments. Co-investments offer LPs the opportunity to selectively invest with managers, often without the fees and carried interest seen at the fund level, allowing LPs to “average down” the fee impact from the GP, or reduce the spread between gross returns and net returns. Higher returns should also be achieved through disciplined selection of strong performing co-investment opportunities. Additional benefits to LPs include the ability to balance a portfolio both geographically and sectorally in an asset class, which typically allows GP more flexibility in where and how they invest.

Nevertheless, Staff has attempted to show the potential positive impact a co-investment program could have on the SCERS portfolio in Chart 1. Chart 1 is a hypothetical demonstration of (1) a \$10 million per year allocation to select co-investments over a three year period of time (\$30 million in aggregate), combined with \$90 million in primary fund investments, equating to a \$120 million aggregate private equity allocation, and (2) \$120 million in primary fund investments over the same period with no co-investments. Note that private equity funds have a five-or six-year investment period. Both examples have the same gross deal return of 20%. The modeled net return on the fund investments is 14.3%, very similar to SCERS' since inception return. The net IRR on the co-investment portfolio is 140 bps higher at 15.7%. While the example in Chart 1 is merely an example (there are a host of external factors to account for), it is directionally correct. These excess returns can be generated by a combination of additive co-investment deal selection, and a lower fee structure.

**Chart 1**



In the public pension plan sphere there are a number of other private equity programs with active co-investment programs:

- For the three-year period ending Dec. 31, 2018, the CalPERS \$2.3 billion co-investment program saw returns of 17.3% compared to the entire \$27.4 billion private equity program's return of 12.3%.
- CalPERS' \$2.3 billion co-investment and direct investment portfolio earned a 3.4% IRR for the one-year period, 9.3% for the five year-period, and 15.3% for the 10-year period ending Dec. 31. By comparison, returns for CalPERS' entire private equity portfolio, including co-investments and direct investments, were 12.5% IRR for the one-year period, 11.3% for the five-year period, and 11.4% for the 10-year period ending Dec. 31, 2018.

**Chart 2**

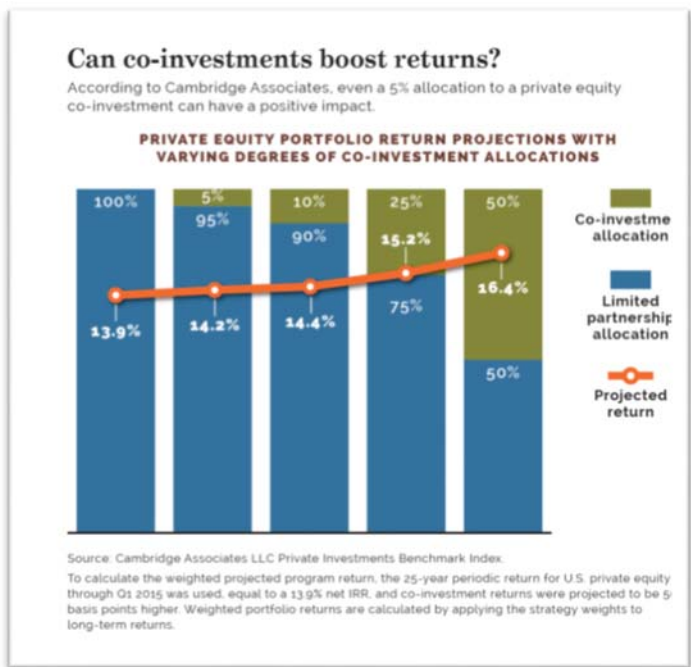


Chart 2 shows data from investment consultant Cambridge Associates that higher allocations to co-investments can result in better net private equity returns. Staff believes that the approach taken to implement a co-investment program, with flexibility and some level of control by SCERS built into the mandate, plays a key role in being able to earn excess returns over primary investments.

SCERS has experience making co-investments within the Real Assets asset class, through a separately managed account with a strategic partner, Pantheon, and within the small market buyout segment of the Private Equity asset class through a commingled fund managed by RCP Advisors. This deal flow is that of the strategic partners, and not that of SCERS' GPs.

Staff and Cliffwater see value in creating a structure to capitalize on the deal flow of its own underlying managers, particularly within the Private Equity asset class, where SCERS is invested in over 50 funds and has relationships with approximately 15+ investment managers. However, managing a co-investment program requires sufficient internal structures and resources, because deal flow can take time to develop, has short decision-making periods, and is time intensive. Staff and Cliffwater expect SCERS to receive reliable deal flow from its GPs.

**POTENTIAL CO-INVESTMENT STRUCTURES**

During the education presentation in April 2019, Cliffwater and Staff highlighted four options for increasing SCERS' co-investment exposure:

**1. Commit to a drawdown co-investment vehicle with a third-party firm.**

This option invests with a third party in a drawdown structure run by a fund of funds manager, using the deal flow from their portfolio of primary fund commitments for co-investments. These vehicles typically charge a 1% management fee and 10%+ carried interest, which is an

expensive structure. Many of these groups have conflicts of interest with transactions going into multiple funds. It is not uncommon for a large fund of funds to invest in co-investments from a co-investment fund, a fund of funds, and separate accounts. With co-investment pools having large portfolios of investments, these are often a beta investment on the overall market. Given the maturity of SCERS' Private Equity Program, investing in this type of structure only makes sense in a specialized format, an example of which is SCERS' investment with RCP Advisors, which specifically targets small and lower-middle market buyout investments, and has a well-aligned fee structure.

**2. Invest in an “Overage Fund,” which are raised by some GPs at the time of investment.**

Some managers raise a captive pool of capital alongside their primary fund which they can use when a transaction is too large for their primary fund. This is often called an “Overage Fund.” Some LPs like to invest in these funds as a method to deploy more capital in a trusted manager with better net economics. Often GPs limit the amount an LP can invest in these funds to a fixed ratio when measured against the primary fund commitment. Only a few managers raise these funds and a reliable source of “Overage Fund” deal flow cannot be relied upon.

Overage Funds can be a way for a GP to manage more significant transactions as well as the time concerns around investing. Overage funds can also be a way for a GP to earn carry on co-investments, as these funds typically have a small fee on invested capital and a carry allocation (10% is the industry standard). Given the nature of Overage Funds, GPs may or may not invest the capital. As an example, Waterland Private Equity, A GP within SCERS' Private Equity portfolio, raised an Overflow Fund at the same time it raised its sixth primary fund in December 2015. SCERS committed €6 million to the Overflow Fund. The fund charged a 1% fee on invested capital only (not committed capital) and 10% fund level carry above a 4% hurdle (half the hurdle rate of the master fund). In December 2018, having not called the capital, Waterland released investors from their commitments on the Overage Fund.

**3. Develop a direct internal investment arm which is expensive and resource-intensive.**

Building a direct program is expensive and requires dedicated staff. Given the current size of SCERS, a direct investment program is not practical.

**4. Hybrid Partner model with a manager who has the experience and resources of a larger firm but allows SCERS a role in the process – *Proposed Structure***

Staff and Cliffwater believe that a “Hybrid” approach to co-investments can be created whereby SCERS would partner with a firm, the “Hybrid Partner,” to underwrite SCERS' GP co-investment deal flow, as well as provide SCERS with access to the strategic partner's deal flow. Staff believes this Strategic Partner (fund of funds, consultant, institutional fund investor, etc.) would help develop this process as a means of increasing their own deal flow as SCERS could potentially share its deal flow with the Partner. Through a close partnership, much like staff had with the Pantheon mandate, the Hybrid Partner should be able to deliver better net returns than investing purely into commingled co-investment funds.

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Staff and Cliffwater propose a hybrid structure to capture co-investment deal flow from SCERS' existing GPs, mostly within the buyout segment of Private Equity, and to provide SCERS with access to the hybrid manager's co-investment deal flow. The structure can also potentially be set up to make co-investments in other private market asset classes such as Real Assets, Real Estate, or Private Credit. A co-investment strategic partner will have dedicated resources to respond to GPs quickly, can underwrite to a fixed schedule, and doesn't impede the deal process.

With an adequately resourced hybrid manager's co-investment team, a transaction can be analyzed for its merits allowing for a prompt decision on a potential opportunity to determine if full underwriting should be undertaken. A good co-investment team is in regular communication with the GP during the investment process, so there aren't any last-minute issues which could complicate an investment from closing.

Co-investment deal flow takes time to develop and must be courted from the underlying managers. Staff understands it will take time and consistent messaging to SCERS' managers to build co-investment relationships. Staff proposes developing a partnership that will initially use the deal flow of the hybrid manager to seed the portfolio, and as SCERS begins to generate deal flow from its own GPs, SCERS will have the hybrid manager underwrite potential opportunities and share in the investment. The relationship should help SCERS receive priority for allocations in future funds.

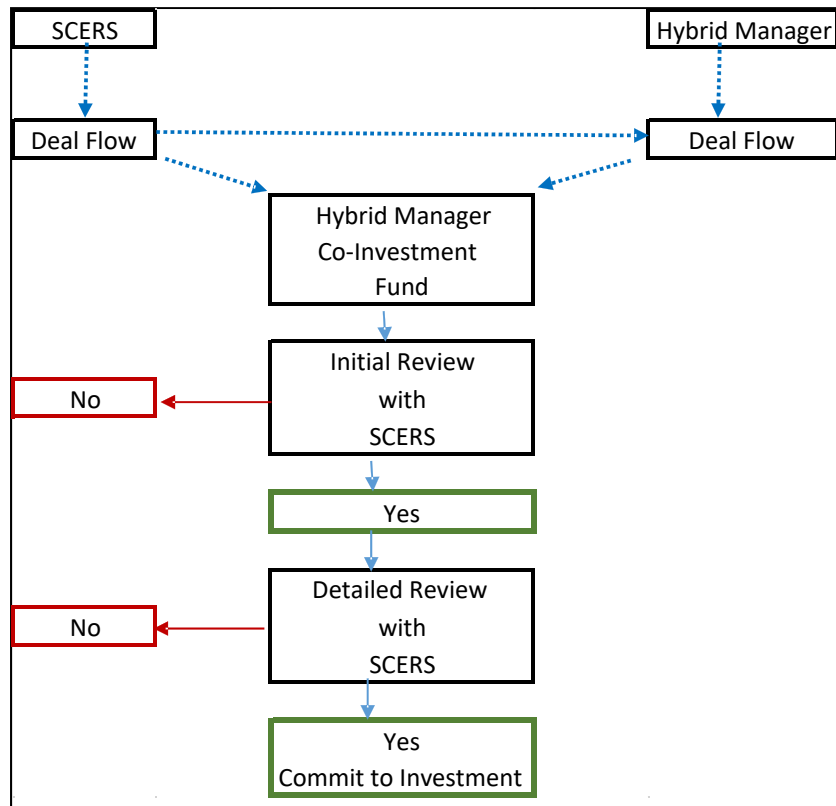
Building a relationship with the hybrid manager will entail developing a clear profile on the types of opportunities that SCERS is interested in, so the hybrid manager can maximize resource efficiency. Within this structure, Staff and consultant (Cliffwater) will play a role in evaluating co-investment opportunities through due diligence materials provided by the hybrid partner, and guide the hybrid manager as to the level of interest. This is similar to the implementation approach utilized with SCERS' real assets co-investment/secondary investment mandate with Pantheon. SCERS must be responsive to the manager as well, and provide a response regarding interest in investment opportunities quickly. The relationship will take time and resources from Staff as a marketing effort is created, and Staff introduces the Hybrid Partner to the underlying buyout portfolio. Concise and consistent messaging to SCERS' GPs about SCERS' ability to underwrite co-investments through the hybrid structure/partner will also take time.

Chart 3 below graphically shows the expected investment process with the Hybrid Partner. The Hybrid Partner and SCERS will develop deal flow from their respective GPs. These opportunities will be initially reviewed by the Hybrid Partner with a short summary for SCERS. SCERS' Staff and the Hybrid Partner will review the headline details for red flags and portfolio fit, at which point Staff will provide an indication of interest to the GP. If there is interest, the Hybrid Partner would begin a more extensive underwriting process, including Staff reviewing the GP's materials on the transaction. Communication with the Hybrid Partner would be close during the underwriting process as a deal can fall away for a host of reasons. A final recommendation will be presented to Staff for a final decision. GPs have stated transparency to the process, speed at making a decision, and ability to fund on time as the qualities of a strong co-investing partner. Staff believes a process as exemplified in Chart 3 will demonstrate to GPs that SCERS is an advantageous co-investment partner to bring into transactions. This

approach requires moderately more time from Staff; however, it has the potential to generate higher returns than making co-investments solely through co-investment commingled funds.

The examples following Chart 3, demonstrate how the process would play out in practice, both for a co-investment originating from one of SCERS' GPs, and for a co-investment originating from the Hybrid Partner.

**Chart 3**



Relationship workflow with Hybrid Partner

**EXAMPLE A:**

SCERS' buyout manager, ABC Fund Mgmt.(ABC), is investing in a business services company which is targeting small to mid-size companies. The manager contacts Staff to see if SCERS would be interested in co-investing in the deal as it is too big for ABC's current fund. Staff would pass the referral on to the Hybrid Manager, who would work on getting more information about the transaction. It is envisioned the Hybrid Manager would prepare a short summary of the deal/transaction highlights, and capital needs. Staff, consultant, and the Hybrid Manager would then discuss the merits of the transaction after which an expression of interest would be communicated to ABC. If there is interest in the transaction, the Hybrid Manager would work with ABC to more fully underwrite the deal and prepare a more detailed investment recommendation for SCERS. Staff and consultant would review the documentation and make a final decision on SCERS' interest level. A transaction may fall out of favor at any point during the process.

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**EXAMPLE B:**

The Hybrid Manager has invested in a fund managed by XYZ Fund Mgmt. (XYZ) that is investing in an outsourcing IT business. The Hybrid Manager would prepare a short summary of the deal/transaction highlights, and capital needs. Staff, consultant, and the Hybrid Manager would then discuss the merits of the transaction after which an expression of interest would be communicated to XYZ. If there is interest in the transaction, the Hybrid Manager would work with ABC to more fully underwrite the deal and prepare a more detailed investment recommendation for SCERS. Staff and consultant would review the documentation and make a final decision on SCERS' interest level. A transaction may fall out of favor at any point during the process.

A clear alignment between SCERS and the Hybrid Manager is imperative. The alignment may come from an investment into the proposed structure from the Hybrid Manager, or an investment into the transactions alongside SCERS. In the case of Example A or B above, if SCERS decided the transaction is not right for the portfolio then the Hybrid Manager may (or may not) underwrite the transaction, without SCERS participating. Regardless, Staff believes that the Hybrid Manager would need to have a mechanism to assure they are being selective in their underwriting and focusing on the best deals stemming from the combined deal flow.

**LEGAL AND FIDUCIARY CONSIDERATIONS**

Staff is in the early stages of performing due diligence on managers who could implement a hybrid co-investment structure. Any recommended manager or structure would contain the proper fiduciary considerations and protections as it relates to implementing the mandate. This would entail working with SCERS' counsel to consider all layers of fiduciary responsibility, including at the level of the Hybrid Manager and the underlying GP who is providing access to the co-investment deal flow. This mandate would be different than investing on a primary basis into a fund, as SCERS would be investing directly into companies and not funds. Therefore, there could be an extra layer of complexity as it relates to fiduciary considerations. As a co-investor, SCERS would not be taking on any liabilities from the company underlying the co-investment, and would be a minority, passive investor in the company. Given the number of public pension plans that invest in co-investments, Staff is confident an amicable structure can be put in place that protects SCERS.

**PROPOSED SIZING**

Staff and Cliffwater anticipate a hybrid co-investment structure up to \$100 million, invested over multiple years (i.e., \$25 million allocations over the next four years), with a flexible approach to pacing depending on deal flow. Any manager recommendation would be presented separately according to the implementation protocol section of the relevant asset category IPS. Based on Cliffwater's capital market assumptions prepared at the beginning of 2019, a \$100 million allocation would represent approximately 13% of the total private equity allocations over the next four years. Based on the existing portfolio, the proposed allocation would represent 5% of the total private equity portfolio. SCERS' allocation to co-investments, inclusive of SCERS' commitment to RCP's co-investment vehicle in small buyouts, would be 7% in 2024. A \$30 million allocation per year is the equivalent to an average-sized primary



commitment (based on the 2018/2019 Investment Year in Review) and would reduce the going forward Private Equity budget by that amount. While there are many approaches to portfolio construction and diversification, Staff and Cliffwater assume a portfolio of approximately five investments per year and \$5 million per investment. A 20-30 company portfolio would allow for higher-performing investments to have a meaningful impact on performance while limiting the impact of underperforming investments.

Assuming private markets holding periods remain constant (Bain stated the holding period for investments is 4.5 years as of 2018) as well as median Private Equity U.S. performance (as of March 2019, the 10-year performance per the Institutional Limited Partners Association is 16.86%) this co-investment structure could be self-funding. The structure as planned would give SCERS the flexibility to scale up or down the program should the plan's liquidity needs change.

### **KEY TERMS TO CO-INVESTMENT PARTNER**

The typical co-investment fee structure for a fund of fund co-investment manager is a 1% management fee and a 10% carried interest. Staff believes the proposed hybrid structure will have a significantly lower fee structure than 1% management fee and 10% carry and will include a higher preferred hurdle rate.

### **NEXT STEPS**

The universe of investment managers that would be interested in providing a hybrid co-investment structure to SCERS is large, but can be reduced to a shortlist by focusing on a few key attributes:

- Track record of investing alongside GPs
  - Selectivity in rationalizing deal flow opportunities
  - Realized track record is vital as many groups are new to strategy and have a mostly unrealized portfolio
- Correct alignment of interest with SCERS, a true partnership
- SCERS' ability to have a role in portfolio construction and implementation
- Complementary set of GP relationships beyond the GPs in the SCERS portfolio. These relationships will allow SCERS to get access to transactions without being an LP. GPs may like SCERS as a co-investor as SCERS could be an investor in these GPs' future funds

Staff and Cliffwater are in the process of performing due diligence on several potential investment managers, with a recommendation and implementation expected during the first half of 2020. A recommendation for an investment manager to implement a hybrid structure for co-investments would take place according to the implementation protocol identified within the investment policy statement for the Growth asset category.

SCERS has built a robust portfolio of GPs relationships and has benefited from a strong performing portfolio of underlying investments. Adding a co-investment program will serve as a complementary component to the Private Equity portfolio as it continues to mature. The

proposed co-investment program is expected to generate potentially higher net returns while providing sufficient diversification to avoid the pitfalls of a concentrated portfolio. A combination of primary fund investments, selective co-investments, and a secondary program (both selling and buying positions) is the natural evolution of a mature private investment program. The proposed hybrid approach offers SCERS flexibility to cost-effectively invest in companies alongside SCERS' highest conviction managers.

**ATTACHMENT**

- Separately Managed Account (SMA) for Co-Investments in Buyouts

Prepared by:

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Jim Donohue  
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# Separately Managed Account (SMA) for Co-Investments in Buyouts



**SCERS**

SACRAMENTO COUNTY  
EMPLOYEES' RETIREMENT SYSTEM

# Opportunity for Co-Investments

- Invest more with high conviction managers
  - Reduce manager proliferation
- Improve net returns and reduce fees
- Aid in balancing portfolio
- Proven strategy with proven managers



# Co-Investments

- Co-investments are direct investments in portfolio companies owned by private equity funds
  - Private investments made “side by side” with a private equity general partner
- Co-investment opportunities typically arise when an investment cannot be fully funded by the fund
  - Often due to fund’s concentration limits or diversification necessities
- Primary objectives for co-investments
  - Earn higher returns
  - Deploy more capital with high conviction managers
- Additional risks associated with co-investments
  - Potential for adverse selection
  - Concentration risk
  - Headline risk



# Co-Investment Approaches

Approach	Description	Cost (Fees/Carry)	Selection/ Breath	Required Resources
Direct Co-Investment	Directly seeking co-investments from existing GPs	Low	Moderate	High
Co-Investment Manager	Hire third party to seek, select and manage co-investments	Moderate to High	High	Low
Hybrid Direct/Manager	Customized approach with dedicated manager	Moderate	Moderate to High	Low to Moderate
Overflow Fund	Side-car vehicle used by GP for investments too large for main fund	Low to Moderate	Low	Low

Co-Investment Manager: RCP Direct III

Overflow Fund: Waterland Private Equity VI

Co-Investment Manager: Pantheon Separate Account

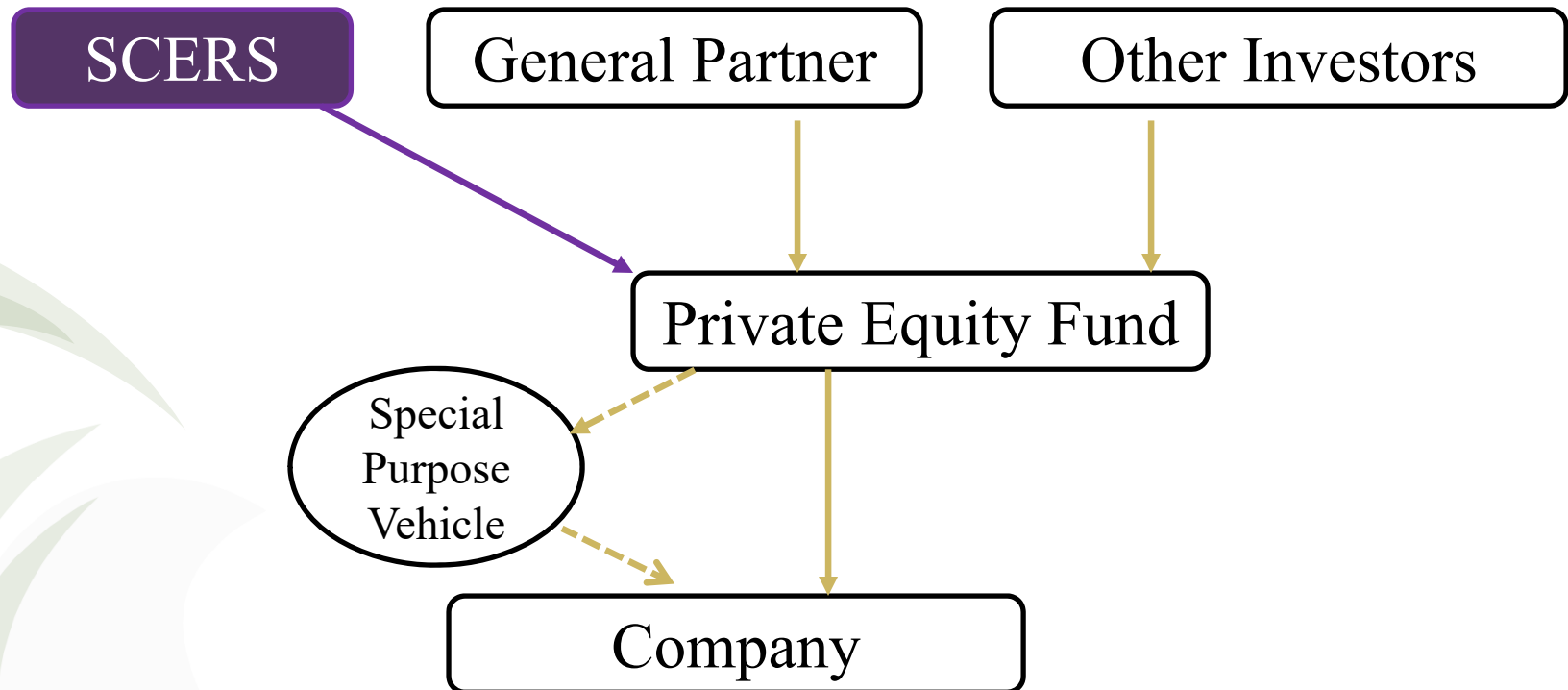


# Hybrid Co-Investment Model

- Components
  - SCERS' General Partners Deal Flows
  - Hybrid Manager's Deal Flow
- Deal Flow Sharing Partnership
  - Clear communication with underlying GPs to maintain strong GP relationships
- Strengthen core relationship with GPs
  - Get a better understanding of how GPs operate with management teams and deal stresses
  - Better understanding of how a deal drives value

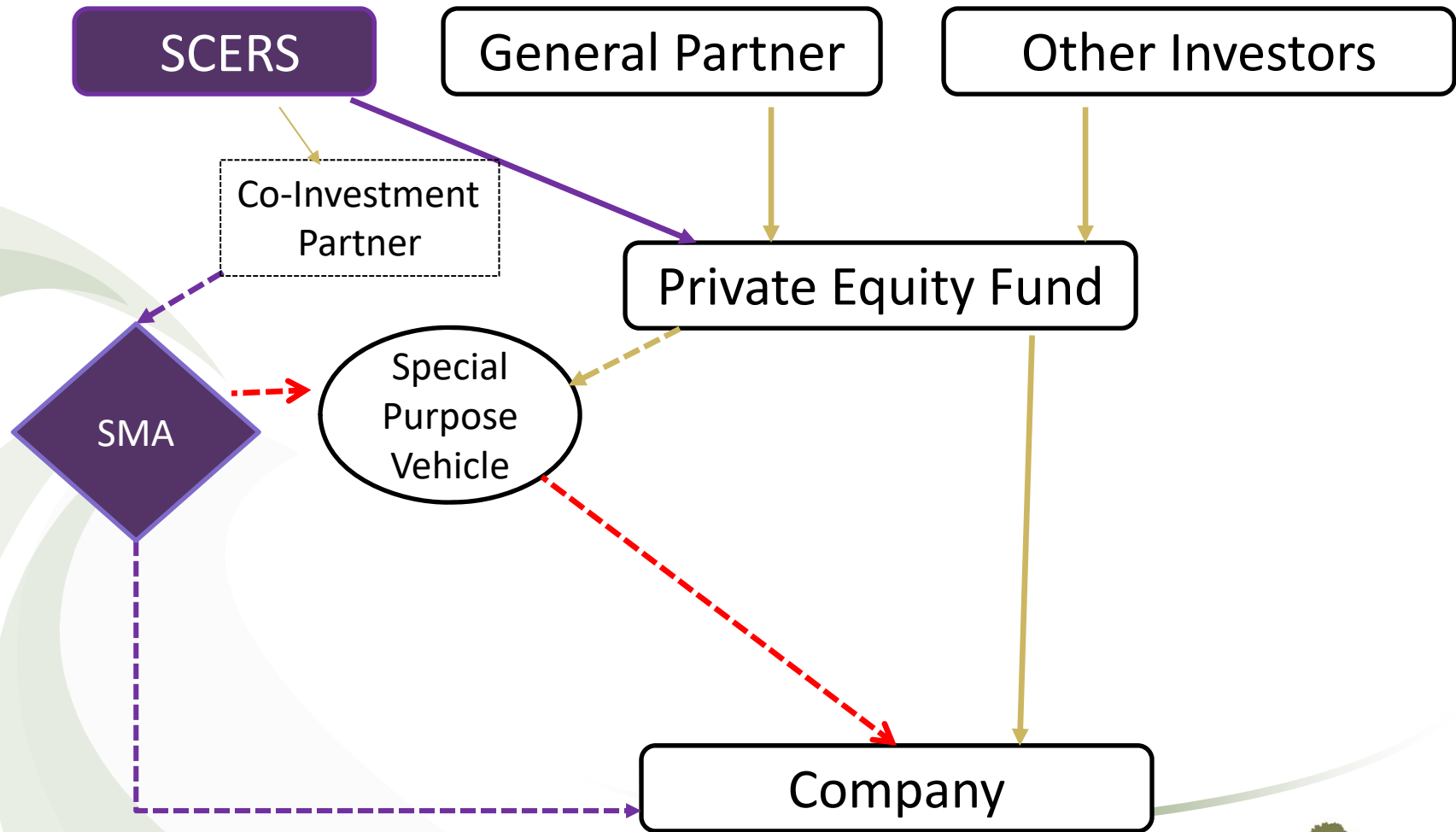


# Typical Deal Structure

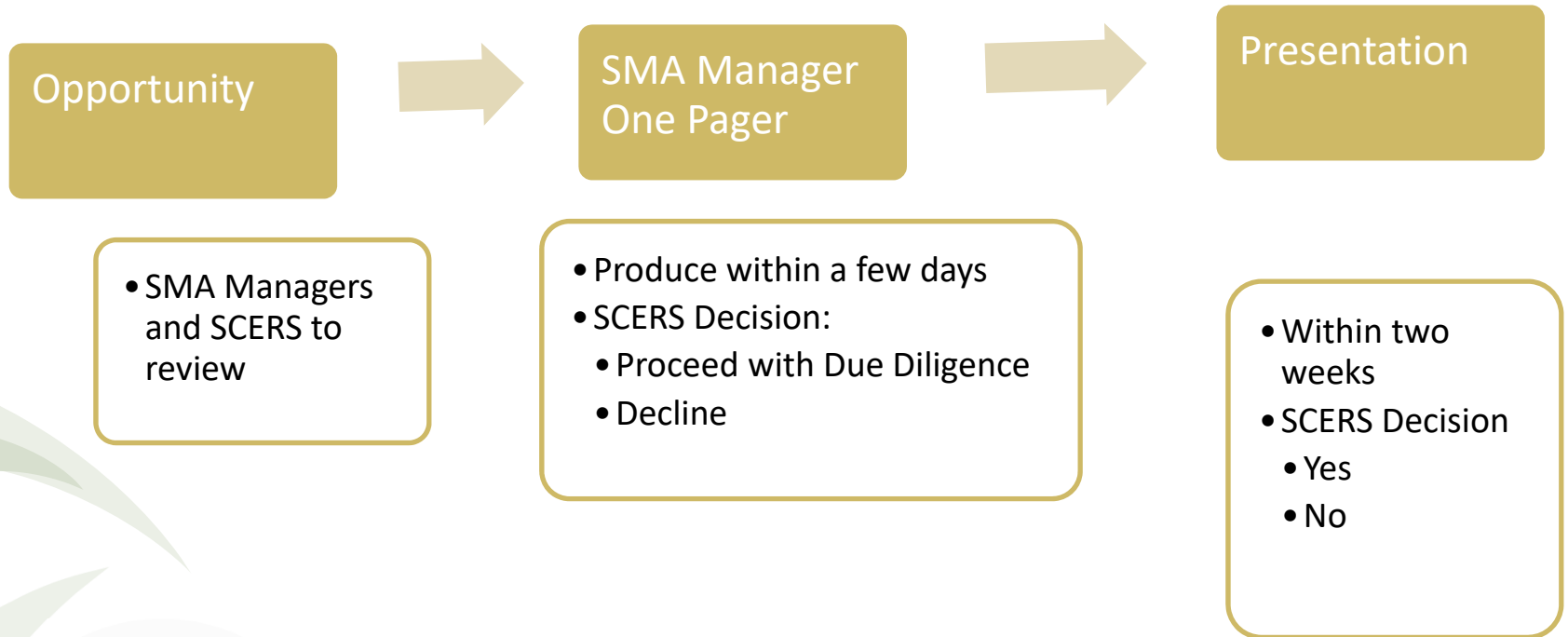




# Proposed Co-Investment Deal Structure



# Process



- **Important to communicate interest levels quickly**
- **Moderate impact to daily work**



# Proposal for Co-Investment Structure

- Flexible structure allows changes to market conditions
- Up to \$100 million allocation over 4 years focused on buyouts
  - Portfolio of 20-30 companies (\$4-6 million per investment)
  - Flexibility to adjust investment pace to match opportunity set
- Initial deal flow to come from Co-Investment Manager
- SCERS' GP relationships increasingly large part of deal flow



# Selection Criteria

- Track Record
- Flexibility
- Cost



## Next Steps:

- Review managers
  - Staff and Cliffwater
- Determine viability of manager universe
- Board recommendation
  - 1<sup>st</sup> half of 2020
- Structure, mandate, and implement

