Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 17

MEETING DATE: **September 15, 2021**

SUBJECT: **Asset Class Restructuring: Private Equity**

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

RECOMMENDATION

Staff recommends the Board approve the proposed implementation plan and revisions to the structure of the Private Equity asset class as presented by Cliffwater and SCERS' Investment Staff. The specific recommendations include:

- Establish range of +/- 3% around the new 11% target allocation (8% - 14%).
- Add Growth Equity sub-strategy to complement the existing Buyout, Venture Capital, and Distressed sub-strategies.
- Maintain the 2021 Private Equity investment plan until the Board approves an updated commitment pacing budget in early 2022.
- Direct staff to make conforming changes to the Growth Asset Category and Master Investment Policy Statements for approval by the Board at a future meeting.

PURPOSE

This item supports the implementation of the revised strategic asset allocation, which calls for Staff and consultants to identify structuring considerations and implementation plans for each major asset class.

PRIVATE EQUITY STRATEGIC CHANGES

SCERS' Board approved a revised strategic asset allocation for SCERS in August 2021, which resulted in the Private Equity target allocation increasing from 9% to 11%. The current allocation to Private Equity is 12.2% as of June 30, 2021, up from 10.6% on March 31, 2021. The run up in the allocation is due the exceptionally strong returns that Private Equity generated over that past year (61.9% for the fiscal year ending June 30, 2021). Private market valuations are lagged a quarter.

The 'Implementation Plan' section for Private Equity below will cover the plan to maintain the Private Equity allocation around the new target allocation of 11%, both over the long- and short-term time periods.

The Private Equity asset class resides within the Growth asset category, and the asset class target allocations are shown below:

Asset Class	Prior Target Allocation	Revised Target Allocation	Actual Allocation
Growth Asset Category	58.0%	58.0%	
Global Equity	40.0%	40.0%	
Private Equity	9.0%	11.0%	12.2%
Public Credit	2.0%	2.0%	
Private Credit	4.0%	5.0%	
Growth Absolute Return	3.0%	0.0%	

RECOMMENDED PRIVATE EQUITY STRUCTURE REVISIONS

Recommendations related to the structure of SCERS' Private Equity asset class are shown below. The recommended changes will go into effect upon Board approval; however, they will not be reflected in the investment policy statement until a later date. Private Equity resides within a broader Growth asset category IPS, along with Public Equities, Public Credit, Private Credit, and Growth Absolute Return. Staff will present a revised Growth asset category IPS at a later date that incorporates the proposed revisions to the Private Equity asset class, as well as the other Growth asset classes, once they are all approved by the Board. The Master IPS will also be updated accordingly.

Private Equity Target and Range:

The prior Private Equity target allocation had a range of +/- 2% around the 9% target as shown below:

Private Equity	Prior Target %	Current Range
	9%	7% - 11%

Staff and Cliffwater recommend extending the Private Equity range from +/- 2% to +/- 3% around the target allocation, as show below. The extended range accounts for the increased target allocation, and allows for greater flexibility in managing a mature private equity portfolio around the target.

Private Equity	New Target %	Recommended Range
	11%	8% - 14%

Private Equity Sub-Strategy Diversification Guidelines:

Staff and Cliffwater recommend adding a 15% target Growth Equity sub-strategy allocation to the Private Equity asset class, with a range of 10% to 35%, to complement the existing Buyout, Venture Capital, Distressed, and Other sub-strategies. The proposed revisions are shown below, including targets and ranges for each sub-strategy. The Growth Equity target allocation will be sourced from the existing sub-strategies.

Current Private Equity Sub-Strategy Allocations:

PE Sub-Strategy	Current Target %	Current Range
U.S. Focused		
Buyout	50%	30% - 70%
Venture Capital	20%	10% - 30%
Growth Equity	-	-
Distressed	10%	0% - 20%
Other	0%	0% - 15%
Non-U.S. Focused		
Buyout	15%	10% - 20%
Growth Equity	-	-
Venture Capital	3%	0% - 10%
Distressed	2%	0% - 10%
Other	0%	0% - 5%

Recommended Private Equity Sub-Strategy Allocations:

PE Sub-Strategy	Recommended Target %	Recommended Range
Buyout	55%	35% - 75%
Venture Capital	20%	10% - 40%
Growth Equity	15%	10% - 35%
Distressed	10%	5% - 30%
Other	0%	0% - 15%
U.S.	80%	70% - 90%
Non-U.S.	20%	10% - 30%

A change in the structure is to group the aggregate sub-strategy allocations across geography (both U.S. and non-U.S.). Under this approach, the sub-strategy target allocations versus the existing targets (combining U.S. and non-U.S.) are as follows:

- Buyout: proposed target of 55% vs. current target of 65%
- Venture Capital: proposed target of 20% vs. current target of 23%
- Growth Equity: proposed target of 15% (new proposed sub-strategy)

- Distressed: proposed target of 10% vs. current target of 23%

Growth equity is a sub-strategy that has emerged over the last decade as a distinctive private equity segment with properties and features of both buyouts and venture capital, and which falls between each on the risk-return spectrum. Growth equity typically make minority investments in more mature and profitable companies looking to further accelerate growth by expanding operations or funding an acquisition. Companies seeking growth capital often reside within the technology sector, as well as healthcare, financial services, and consumer goods and services.

Growth equity differs from venture capital in that it invests in high growth companies at more mature stages of their lifecycle, whereas venture capital invests in companies at the earlier stages of their development, and which have a higher percentage of companies that will ultimately fail combined with a fewer number of companies that will be ‘home run’ investments. Growth equity firms typically take less technology risk and more business execution risk compared to venture capital, and as a result, will generally generate a higher IRR and a lower multiple.

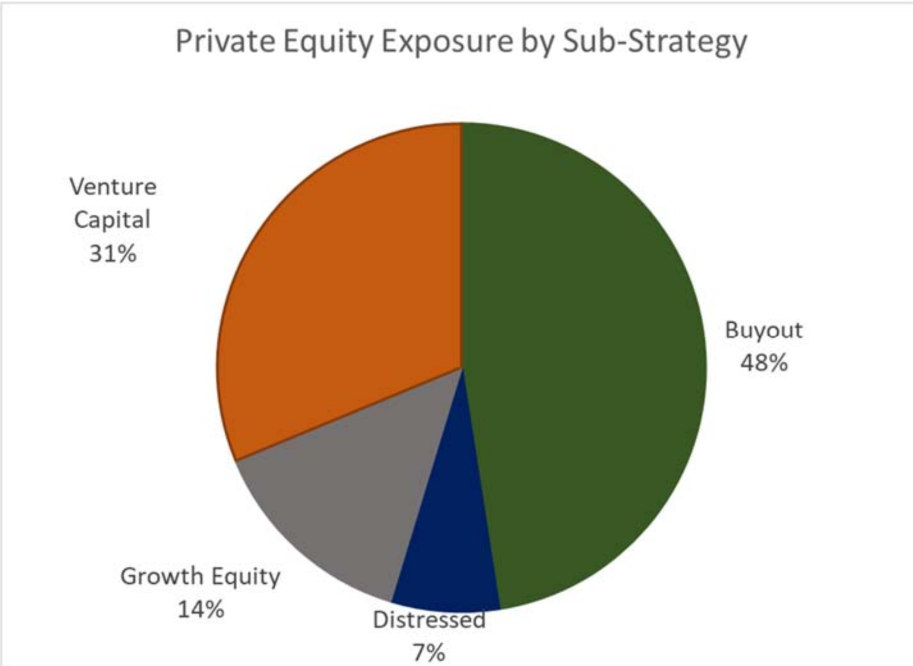
Growth equity differs from buyout in that buyout funds typically acquire a majority stake in a company (often 100%), and buyout companies are generally more established companies with longer histories, whereas growth equity are typically structured as minority investments where an investor has more limited control over a given company.

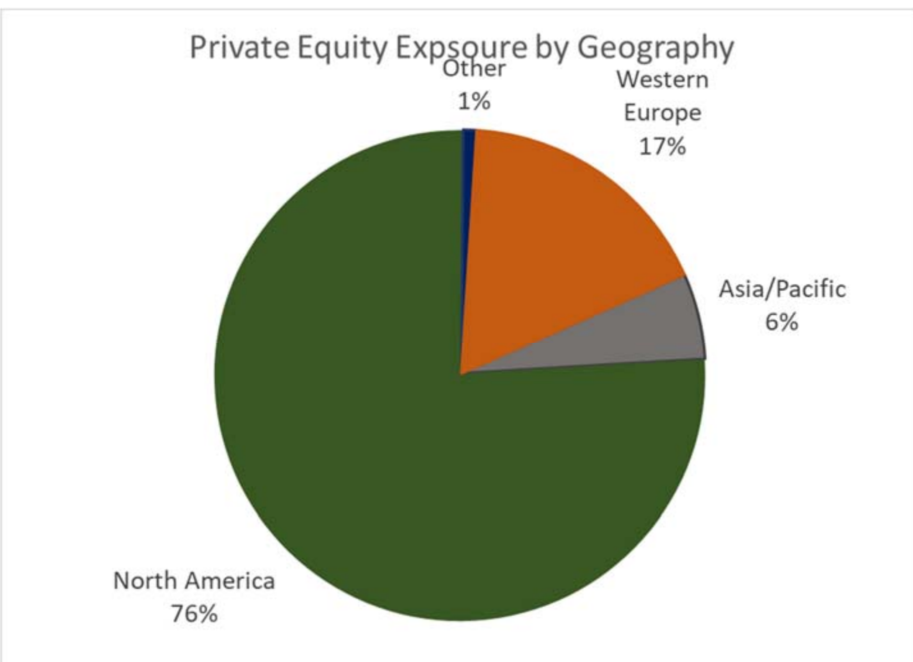
Under the current Growth IPS, growth equity is categorized by SCERS as a Buyout investment, however, based on the characteristics of an underlying fund, it can be categorized as either Buyout or Venture Capital. Cliffwater often categorizes growth equity as Venture Capital, and creating a Growth Equity allocation will allow for improved harmonization between SCERS and Cliffwater as it relates to categorization. Staff and Cliffwater have identified ten funds in the current SCERS portfolio that would be reclassified as Growth Equity. These include:

- Accel-KKR Growth Capital Partners II, LP
- Accel-KKR Growth Capital Partners III, LP
- Spectrum Equity VII, LP
- Spectrum Equity VIII, LP
- Spectrum Equity IX, LP
- Summit Partners Europe Growth Equity Fund II, SCSP
- Summit Partners Europe Growth Equity Fund III, SCSP
- Summit Partners Venture Capital III, LP
- Summit Partners Venture Capital IV, LP
- Summit Partners Venture Capital V, LP

The two Summit Partners Europe Growth Equity funds would be categorized as non-U.S Growth Equity, while the other funds would be categorized as U.S. Growth Equity.

With the re-categorization of the aforementioned existing funds to Growth Equity, SCERS' current Private Equity exposures by strategy and geography are shown below (as of March 31, 2021):





PRIVATE EQUITY INVESTMENT PLAN

With the increased allocation to Private Equity (9% to 11%), Staff and Cliffwater have revisited the capital budget pacing for Private Equity. Given that the calendar year 2021 is nearly complete, Staff and Cliffwater recommend that SCERS maintain the 2021 Private Equity commitment budget of $200 million, which was approved by the Board in February 2021. Cliffwater and Staff will come back in early 2022 with an updated 2022 commitment budget and multi-year capital budget model that incorporates the 11% Private Equity target allocation, as part of the 2022 Annual Plan for Private Equity.

As referenced earlier, the current allocation to Private Equity is 12.2% as of June 30, 2021, up from 10.6% on March 31, 2021. The run up in the allocation is due the exceptionally strong returns that Private Equity generated over that past year (61.9% for the fiscal year ending June 30, 2021). Private market valuations are lagged a quarter. The Private Equity pacing budgets that will be presented for the 2022 calendar year will lay out the plan to maintain an 11% target allocation over the long-term.

The budgets incorporate several variables and assumptions, such as plan assets, the growth rate of the plan (SCERS' actuarial rate adjusting for plan cash outflows), capital market assumptions for private equity, and capital drawdown and distribution assumptions for underlying funds). Cliffwater completed some preliminary modeling for SCERS using the new target allocation of 11%, and not surprisingly, the annual commitment budgets will increase for 2022 and going forward. The larger commitment budgets are a function of the growth in SCERS' plan assets, the increased 11% target to Private Equity, and expected distributions from legacy SCERS private equity funds. As communicated previously, SCERS' Private Equity program is mature to the point where it is cash flow positive, meaning distributions from underlying funds generally outpace capital being drawn for committed to funds. Cliffwater's capital budget model estimates that SCERS' Private Equity portfolio will get back to the 11% target in 2022 or 2023.

Should the Private Equity allocation continue to grow ahead of the 11% target, there are other levers to utilize over the short-term in order to more quickly rebalance the asset class. One tool is the private equity secondary market. Private equity fund commitments are illiquid investments with 10-12 year fund structures. Secondary investing is the buying or selling of single funds or portfolios of funds from LPs seeking early liquidity. Staff and Cliffwater believe SCERS' Private Equity portfolio has matured to the point where a formal process should be in place for the potential secondary sale of existing private equity positions if needed.

Selling a private equity fund/position on the secondary market may occur for a number of reasons including: removing underperforming funds to reinvest in better opportunities, reducing the general partner count, and locking in the performance of a strong performing fund. Most secondary sales would occur through an intermediated market, and there are several high quality funds within SCERS' existing portfolio that could be potential candidates for sale, as needed. Any potential secondary fund sales would not be forced sales at significant discounts, but rather strategic sales to assist SCERS in achieving the long-term objectives of the asset class. Staff and Cliffwater plan to present education around using the private market secondary markets at an upcoming Board meeting, including considerations around process, implementation protocols, and investment policy statement modifications.

NEXT STEPS

- Present the 2022 Private Equity Annual Investment Plan in early 2022.
- Incorporate approved Private Equity structure changes into the Growth asset category and Master IPSs.
- Continue discussions with the Board around process for potential private equity secondary sales.

ATTACHMENTS

- Board Order
- Cliffwater Private Equity Portfolio Structuring Considerations Presentation

Prepared by:	Reviewed by:
/S/	/S/
Steve Davis	Eric Stern
Chief Investment Officer	Chief Executive Officer

Retirement Board Order

Sacramento County Employees' Retirement System

Before the Board of Retirement
September 15, 2021

MOTION:

Asset Class Restructuring: Private Equity

THE BOARD OF RETIREMENT hereby accepts the recommendation of staff to approve the implementation plan and make the following revisions to the structure of the Private Equity asset class:

- Establish range of +/- 3% around the new 11% target allocation (8% - 14%).
- Add Growth Equity sub-strategy to complement the existing Buyout, Venture Capital, and Distressed sub-strategies.
- Maintain the 2021 Private Equity investment plan until the Board approves an updated commitment pacing budget in early 2022.
- Direct staff to make conforming changes to the Growth Asset Category and Master Investment Policy Statements for approval by the Board at a future meeting.

I HEREBY CERTIFY that the above order was passed and adopted on September 15, 2021 by the following vote of the Board of Retirement, to wit:

AYES:

NOES:

ABSENT:

ABSTAIN:

ALTERNATES (Present but not voting):

Richard B. Fowler II
Board President

Eric Stern
Chief Executive Officer and
Board Secretary

CLIFFWATER LLC

Los Angeles • New York

Sacramento County Employees' Retirement System

Private Equity Portfolio Structuring Considerations

September 15, 2021

Private Equity Program Objectives

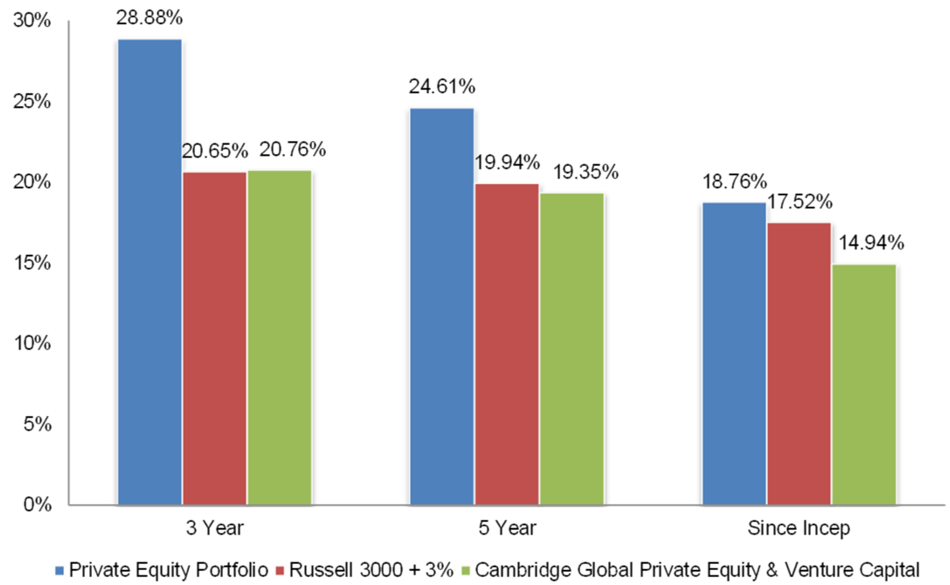
The SCERS Private Equity portfolio is intended to enhance total fund performance

- Expect to outperform public equities by 3% annually over the long-term
- Performance should also compare favorably to industry universes of private equity funds

The Private Equity portfolio has been meeting its objectives and there are no recommended changes to the stated portfolio objectives

- The recommended changes reflect implementation considerations following the 2021 asset liability modeling study and the continued maturation of the SCERS Private Equity portfolio

SCERS Private Equity Portfolio Performance*



* *IRRs as of March 31, 2021*

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Summary of Private Equity Structuring Recommendations

- Adopt a permissible range of 8% to 14% around the new 11% target allocation
  - The current Private Equity allocation is 12.2% as of June 30, 2021
- Create a new Growth Equity strategy category within Private Equity and adopt new Private Equity strategy allocation targets and ranges
  - The new Growth Equity category would provide better classification of funds that straddle the current definitions of Buyout and Venture Capital
    - Appropriate for SCERS' increasingly diverse and mature Private Equity portfolio
  - Also recommending reclassifying existing fund investments as appropriate
    - The funds were primarily classified as either Buyout or Venture Capital funds
- Maintain the current commitment pacing plan for the remainder of 2021
  - SCERS has a $200 million commitment budget target in the approved 2021 Annual Plan
  - Planning to set the 2022 commitment budget with the upcoming 2022 Annual Plan
  - Forecasting SCERS' Private Equity allocation remains within the recommended permissible range and returns to the target allocation within 12 to 18 months
- Continue educational discussions around private equity secondary sales
  - Although SCERS has no immediate needs for secondary sales, formalizing a process is beneficial now that SCERS has reached its targeted allocation

Growth Equity Recommendations

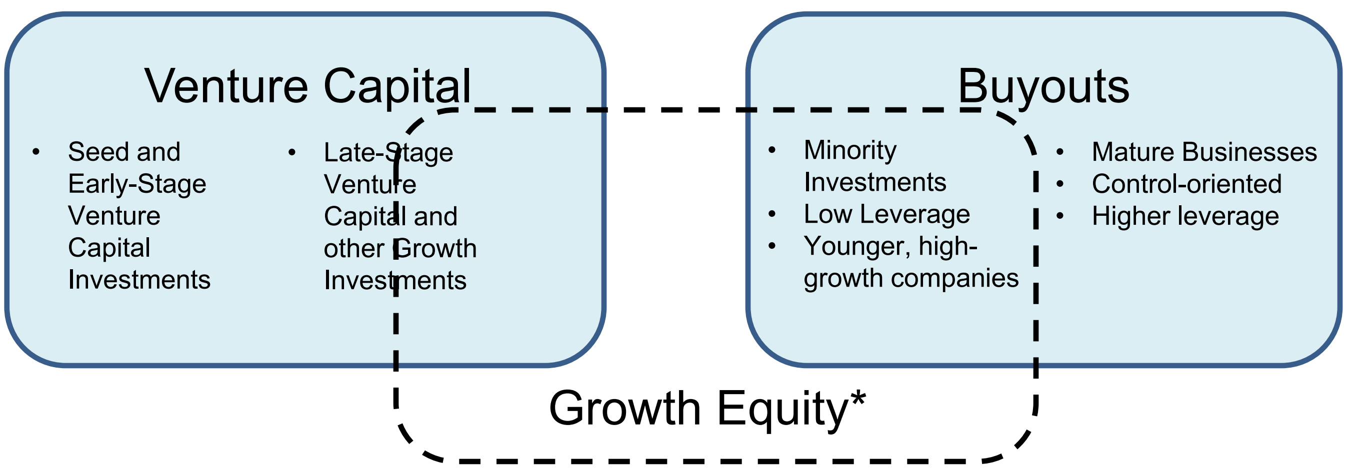
Recommend creating a new Growth Equity strategy category within Private Equity

– The impetus for specifying a new strategy is to provide further strategy granularity for SCERS' increasingly diverse and mature Private Equity portfolio

– Private Equity funds classified as Growth Equity generally have traits that previously aligned with Venture Capital or Buyouts

  - Creating a new category would not result in SCERS pursuing investment strategies not previously considered for Private Equity

– Creating the Growth Equity category should also limit "definitional differences" when placing funds into either Buyouts or Venture Capital without having a Growth Equity option



** The diagram is illustrative of typical traits of Private Equity funds that could be considered within the Growth Equity category.*

Growth Equity Recommendations

Recommend reclassifying the following existing fund investments as Growth Equity

- Accel-KKR Growth Capital Partners II
- Accel-KKR Growth Capital Partners III
- Spectrum Equity VII
- Spectrum Equity VIII
- Spectrum Equity IX
- Summit Partners Europe Growth Equity Fund II
- Summit Partners Europe Growth Equity Fund III
- Summit Partners Venture Capital III
- Summit Partners Venture Capital IV
- Summit Partners Venture Capital V
    - The total market value of these funds represents 13.7% of the Private Equity portfolio at 3/31/21

Recommending a 15% target allocation to Growth Equity, with a recommended allocation range of 10% to 35%

- The detailed allocation target and range recommendations for the entire Private Equity portfolio are shown on the following page

Private Equity Allocation Targets and Ranges

Shown below are the current and recommended targets for the Private Equity strategy, geographic, and total portfolio allocations

	Current Target %	Recommended Target %	Recommended Range
Buyout	65%	55%	35% - 75%
Venture Capital	23%	20%	10% - 40%
Growth Equity	N/A	15%	10% - 35%
Distressed & Debt Related	12%	10%	5% - 30%
Other	0%	0%	0% - 15%
U.S.	80%	80%	70% - 90%
Non-U.S.	20%	20%	10% - 30%
Total Private Equity	11%*	11%*	8% - 14%

** The Total Private Equity target allocation was approved with the 2021 asset liability modeling study*

Private Equity Commitment Pacing Recommendations

Cliffwater updated the SCERS Private Equity portfolio allocation forecasts to reflect current portfolio market values and SCERS' new 11% Private Equity target allocation

- Recommend maintaining the current commitment pacing plan for the remainder of 2021
  - The projections assume SCERS meets its $200 million commitment budget target for 2021
  - All other assumptions are consistent with the projections included in the 2021 Annual Plan

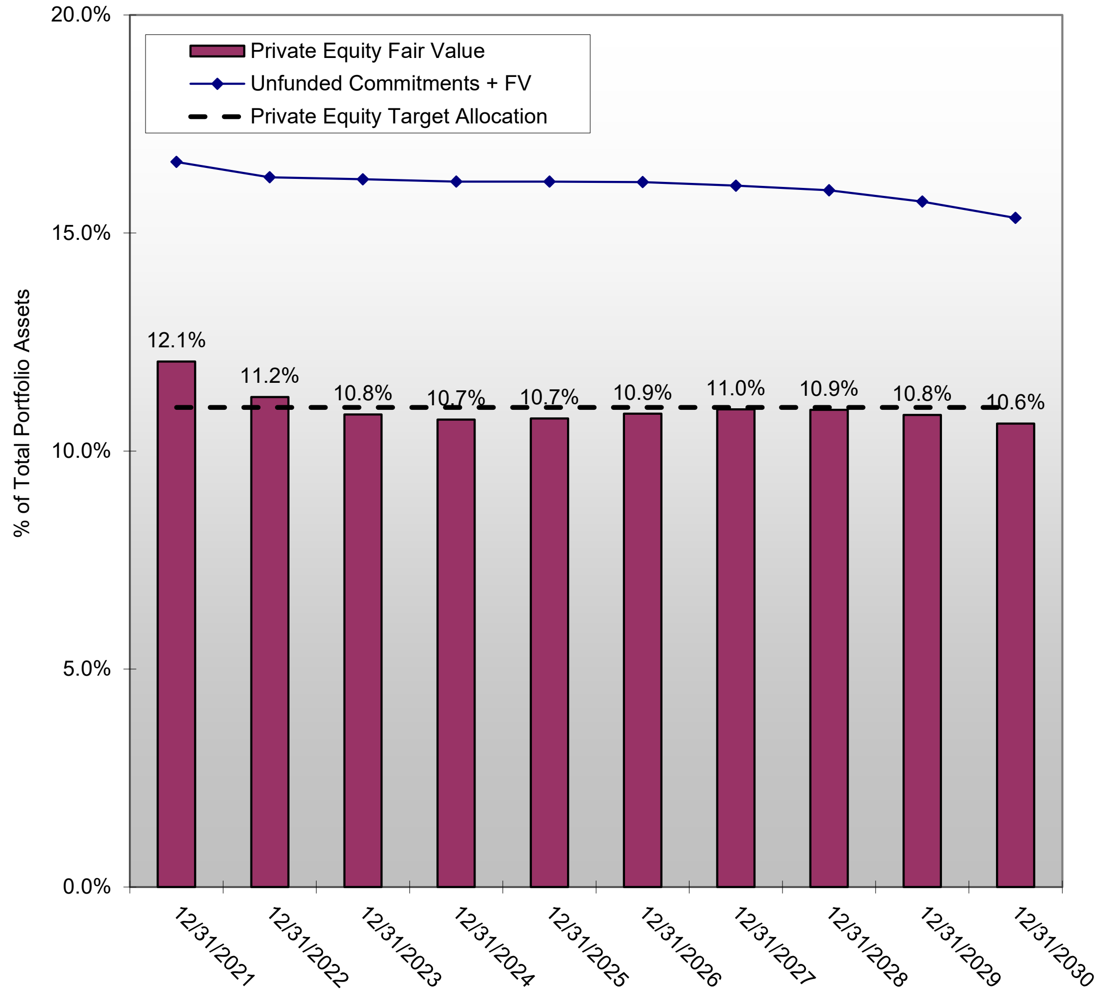
Recommend setting the 2022 commitment budget with the SCERS 2022 Annual Plan

- Currently expect larger budgets in 2022 and beyond given SCERS' fund size growth, expected Private Equity distributions, and the new 11% allocation target

Projecting that SCERS remains within the recommended permissible range for its Private Equity allocation and returns to the target allocation within 12 to 18 months

- The graph on the following page shows the forecasted Private Equity allocations

Private Equity Allocation Forecasts



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Private Equity Secondary Sales

Secondary sales involve the sale of existing funds from one LP to another

- Transactions are privately negotiated, may be arranged by an intermediary
  - Single fund transactions can be sourced directly; portfolio sales often involve intermediaries
  - The private equity fund's general partner must agree to the transaction

Primary objectives for secondary sales

- Consolidate general partner relationships (i.e. limit general partner/fund proliferation)
  - Sell existing funds where the LP does not plan to continue investing in subsequent funds
- Manage overall exposure and/or reduce existing unfunded commitments
- Minimize impact of an underperforming fund while reinvesting in better opportunities

The relative attractiveness of secondary sales is driven by the selling price and timing

- Requires an assessment of future fund performance versus pricing of the transaction

SCERS current Private Equity portfolio

- No immediate need for secondary sales
- SCERS has a high-quality portfolio of funds to select secondary sale candidates as needed
  - Would not expect "forced selling" of funds at significant discounts
- Plan to continue discussions with the SCERS Board to formalize a process for any potential secondary sales

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Next Steps

Recommend Investment Policy Statement changes

- The recommended Private Equity structure changes go into effect upon Board approval
- The Growth asset category IPS will be revised at a later date
  - The IPS revisions will include Private Equity updates and other Growth asset class updates
  - The Master IPS will also be revised at a later date

Present the 2022 Private Equity Annual Investment Plan in early 2022

- Will include recommended commitment pacing

Continue discussions with the SCERS Board around processes for potential private equity secondary sales

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