



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 19

MEETING DATE: September 15, 2021

SUBJECT: Education: Private Equity Co-Investment Structure

SUBMITTED FOR: ___ Consent ___ Deliberation and Action X Receive and File

RECOMMENDATION

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

PURPOSE

This agenda item supports the Strategic Management Plan objective to leverage external experts to maximize investment guidance and results.

SUMMARY

In October 2019, Staff and Cliffwater provided an initial education session about using a co-investment instructure in the private equity asset class. Since then, Staff and Cliffwater have continued to explore this strategy and are currently researching potential co-investment partners. This agenda item is being provided to refresh the Board on implementation and legal considerations as Staff and Cliffwater prepare to make a recommendation to the Board on a co-investment investment manager in coming months.

Staff and Cliffwater have worked to develop a plan allowing SCERS to invest more capital with higher conviction private equity 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 (IPSs). 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 Growth asset category IPS.

BACKGROUND

A co-investment is an investment into a company alongside a GP's commingled fund, often without paying manager fees or carried interest, although the co-investor is typically responsible

for its own expenses and a pro-rata share of deal costs. GPs look to bring in 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 net 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 by sector in an asset class, which typically allows GP more flexibility in where and how they invest.

In the public pension plan sphere, there are a number of other California public pension plans that participate in co-investments including CalPERS, CalSTRS, Orange County Employees’ Retirement System, San Francisco Employees’ Retirement System, and Los Angeles County Employees’ Retirement Association. 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.

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.

POTENTIAL CO-INVESTMENT STRUCTURES

As outlined in the October 2019 presentation, there are 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.

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. Only a few managers raise these funds and a source of “Overage Fund” deal flow cannot be relied upon.

3. Develop a direct internal investment arm.

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 favor a “Hybrid” approach to co-investments 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 the Strategic Partner (fund of funds, consultant, institutional fund investor, etc,) will 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.

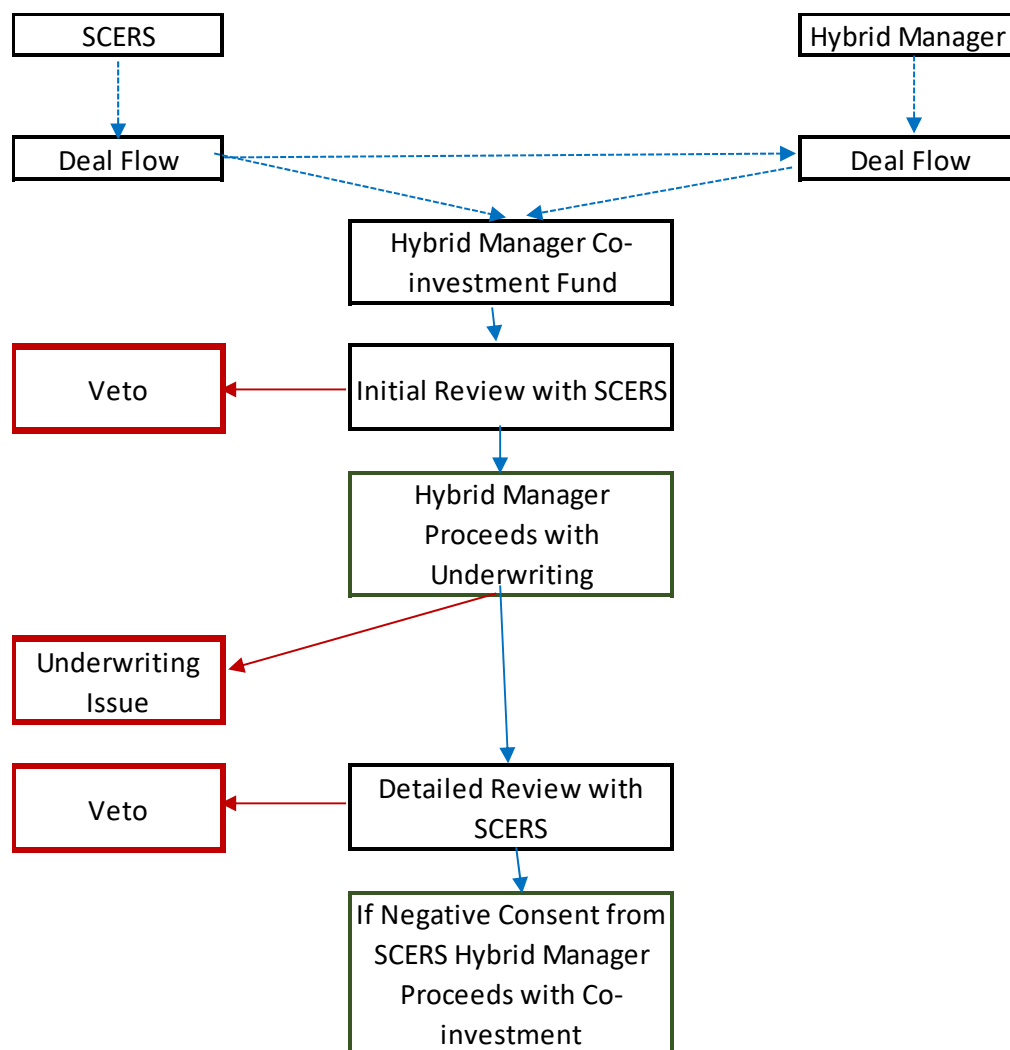
Staff and Cliffwater expect a hybrid structure to capture co-investment deal flow from SCERS’ existing GPs, mostly within the buyout segment of Private Equity, and to provide SCERS with access to the hybrid manager’s co-investment deal flow. The structure can also potentially be set up to make co-investments 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.

Co-investment deal flow takes time to develop and is courted from 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, we will have the hybrid manager underwrite potential opportunities. If there is excess deal flow capacity, SCERS can potentially share this with the hybrid manager partner, as sharing of deal flow is a win-win for both parties. GPs will also appreciate getting to know SCERS through the process as we could be a future investor in their fund. GPs will also appreciate the specialized resources SCERS has in looking at its co-investments.

The graph below 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 final review. Although the Hybrid Partner would have authority to consummate deals, this would require sharing full underwriting information with SCERS, which would have negative consent capabilities. GPs stated that transparency to the process, speed at making a decision, and ability to fund on time are the qualities of a strong co-investing partner. Staff believes a process as exemplified in the graph below will demonstrate to GPs that SCERS can be a valuable co-investment partner. It requires moderately more time from Staff; however, it has the potential to generate higher returns than making co-investments solely through co-investment commingled fund.

The examples in the following chart, 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.



Relationship workflow with Hybrid Partner

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.

Please see the attached Appendix A for a summary of the key terms on which the Hybrid Manager would be performing diligence on when considering a co-investment.

LEGAL AND FIDUCIARY CONSIDERATIONS

As Staff moves forward with developing this co-investment structure and selecting a Hybrid Manager, Staff's primary legal objective will be to ensure that SCERS is afforded a high degree of liability protection by both. Foremost, the Hybrid entity should be set up as a limited liability vehicle (e.g., LLC or LP) with the Hybrid Manager as the active managing member/partner and SCERS as the more passive limited member/partner. In addition, the Hybrid Manager should be subject to a prudent expert standard of care, particularly with respect to sourcing, underwriting, and other investment decisions. The Hybrid Manager should also be willing to accept legal accountability for all investment activity by the Hybrid entity, including in the event that SCERS is sued in connection with such investments. Finally, the level of input that Staff retains in the Hybrid entity's investment activity should not jeopardize SCERS' liability protection. That is, Staff should refrain from a level of activeness that would undermine the Hybrid Partner's agreed-upon role, responsibility, and accountability as the Hybrid entity's manager and fiduciary decision-maker. Because it is currently unknown precisely what of the above terms the Hybrid Partner would ultimately agree to, some of the particulars of the model described herein are subject to change.

PROPOSED SIZING

Staff and Cliffwater anticipate a hybrid co-investment structure up to \$100 million, invested over multiple years (i.e., \$33 million allocations over the next three years), with a flexible approach to pacing depending on deal flow. The manager recommendation would be presented separately according to the implementation protocol section of the Growth asset category IPS. A \$30 million allocation per year is the equivalent to an average-sized primary commitment (based on the 2021 investment plan) 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 six 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. The structure as planned would give SCERS the flexibility to scale up or down the program should the plan's liquidity needs change. It is also expected that SCERS would also have the ability to end the investment period at any time.

KEY TERMS TO CO-INVESTMENT PARTNER

A 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% and 10% and will include a higher preferred hurdle rate.

NEXT STEP

Staff and Cliffwater are in the process of finalizing due diligence on a potential investment manager, with a recommendation and implementation expected during the fourth quarter of 2021. 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 GP relationships within private equity, 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.

ATTACHMENTS

- Board Order
- Appendix A: Summary of key terms
- SCERS Presentation on Co-Investment Structure
- Foley & Lardner LLP Presentation

Prepared by:

/S/

Jim Donohue
Deputy Chief Investment Officer

Reviewed by:

/S/

Steve Davis
Chief Investment Officer

Reviewed by:

/S/

Eric Stern
Chief Executive Officer

/S/

Stephen Lau
General Counsel



Retirement Board Order

Sacramento County Employees' Retirement System

**Before the Board of Retirement
September 15, 2021**

MOTION:

Private Equity Co- Investment Structure

THE BOARD OF RETIREMENT hereby accepts the recommendation of staff to receive and file the presentation related to a preferred investment structure for making co-investments within the private equity asset class.

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

APPENDIX A

The following represents a summary of some of the key details on which the Hybrid Manager (i.e. the general partner or equivalent entity that will make co-investments on SCERS' behalf), in consultation with SCERS, will need to focus in performing diligence with respect to the legal terms of any co-investment vehicle in with the Hybrid entity may seek to invest. This is not an exhaustive list, but rather represents a summary of those terms that most frequently create issues and can make the difference in whether the terms of a co-investment are acceptable to an investor like SCERS.

Key Terms	Foley Commentary
<p>No fee/no carry: Including no “administration fee” or other recurring charges similar to management fees.</p>	<p>Co-Invest Vehicles (“CIV”) typically have reduced or no management fees and carried interest. In certain instances, the GPs may charge administrative fees or other recurring charges that mirror a management fee, so it will be imperative to monitor the legal documentation for any such fees and to ensure contractual protection so that the GP cannot amend agreements to layer on additional fees. To the extent that a co-investor invests in two or more separate CIVs that invest alongside the main fund, there is usually no ability to offset any losses incurred by one CIV against the gains made by another CIV when calculating any carried interest payable in the event that some are successful but others are not.</p>
<p>Investment Terms: Adequate assurance of underlying transaction’s economic terms.</p>	<p>A co-investment structure does not invest through the main fund, but rather directly in a holding vehicle/portfolio company. Accordingly, the agreements that underlie the CIV, are important and should not be overlooked. Many times, the provisions regarding alignment of economic terms can contain potential traps – e.g., qualifications (such as adding “generally” or “substantially” as qualifiers) to the requirement that economic terms are at the same time and on the same terms as those as the main fund.</p>
<p>Alignment: Investment and disposition at substantially the same time, proportion and economic terms as the main fund. Any exceptions due to legal/regulatory requirements may not result in SCERS receiving less favorable economic terms in any material respect.</p>	<p>Tag-Along Rights: Typically we would see tag-along rights permitting a CIV to tag-along on a sale by the main fund of any portion of its interest in the underlying investment. Certain sales or transfers may be excluded from triggering a tag-along, e.g., a sale to management or affiliates or a sale that would not reduce the main fund’s investment holding below a specified threshold (usually a percentage).</p> <p>Drag-Along Rights: Typically there will be drag-along rights allowing GP/manager to require all co-investors to sell a pro rata portion of their interests on the same or substantially the same terms as the main fund. The threshold for triggering drag-along right varies but we often see the sale of 40-50% or more of the main fund’s interest as the triggering threshold.</p>

<p><u>Pre-emptive Rights:</u> Investment aligned with the main fund and other equity holders of an underlying portfolio company so that co-investor prevent their ownership interest from being diluted by future issuances of equity, with certain exclusions.</p>	<p>Co-investors will often request, and typically be granted, the right to participate in future offerings of a holding company’s equity interests on a pro rata basis. We will want to ensure that these rights are structured as a right to exercise and not an obligation and that such rights pick up options, warrants and other securities that may be convertible into equity of a CIV or applicable portfolio company. Generally, there will be exclusions for certain issuances made in connection with strategic transactions, as part of employee equity incentive plans, or issued as equity kickers to lenders. Some CIVs allow co-investors that elect to participate in follow-on investments the option to elect to receive more than their pro rata share of such opportunity in the event that other co-investors do not exercise their rights to participate in full.</p>
<p><u>Syndication:</u> Dollar limit on main fund’s ability to syndicate down its investment and time limit on syndication process.</p>	<p>A concern for co-investors because it has the potential to decrease the GP’s “skin in the game.” A lengthy syndication process also carries the potential to distract the sponsor from managing the investment – so we would typically seek to limit the period during which a post-closing syndication can take place (e.g., to three to six months). Additionally, co-investors generally seek to establish a minimum equity hold for the GP either by percentage or some threshold dollar amount. A potential trap area is that the main fund may be allowed transfer rights to an affiliate without triggering any co-investor liquidity rights – which can result in a potential backdoor for syndication.</p>
<p><u>Expenses:</u> Some form of cap on operating and organizational expenses for which LPs are liable.</p>	<p>Each co-investor typically pays its pro rata portion of the CIV’s organizational and operating expenses, which are often capped at some percentage of the total commitment. Co-investors are typically responsible for any fees they incur while negotiating the CIV’s governing documents. Additionally, we want to make sure that the main fund is allocating expenses pro-rata between the main fund and the applicable CIV. Finally, we want to be careful of attempts to exempt certain expenses from the cap, such as indemnity.</p>

<p>Expenses Transparency: Either capital call notices for expenses or quarterly/annual reporting should include the amounts of expenses charged to LPs.</p>	<p>Formation and transaction expenses are typically funded up-front, when co-investors fund their capital commitment. Operational expenses can be funded annually as incurred, withheld from distributions or funded up-front for the life of the CIV. If operational expenses are funded up-front, investors should ensure that the GP is obligated to return any unused portion at the end of the life of the CIV. We will want to ensure that, mechanically, we have transparency and information rights to understand the amount of estimated operational expenses early in the process so that we can secure approval from the investment committees for their expense commitment in addition to their capital commitment.</p>
<p>Conflicts of Interest: No material transactions between GP/affiliates and the CIV/subsidiaries/holding companies, unless (1) approved by at least majority at interest of CIV LPs, (2) substantially identical transaction is approved by main fund LPAC and transaction does not disproportionately impact the CIV, or (3) GP determines in good faith that the transaction is on arm's-length terms.</p>	<p>Please note that with respect to prong (1), although this provides the greatest protection for co-investors, the GP will often oppose such protection on the basis that this is unduly limiting on the GP's flexibility to manage the investment. Prongs (2) & (3) are more typical compromises but they are not without risk. Prong (2) provides protection, but it's important to note that the composition and the interests of the investors between the main fund and the CIV will differ, so the main fund LPAC may be incentivized to make a decision that is not necessarily the best decision for the CIV. With respect to Prong (3), it's important to note that in a P.E. context it can be difficult to demonstrate that a particular fee-bearing agreement does not reflect arm's length terms.</p> <p>Note that co-investment vehicles generally will not have their own LPAC.</p>
<p>Broken Deal Expenses: SCERS will not be obligated to make any capital contribution, including for partnership costs or expenses, if underlying transaction does not close.</p>	<p>Co-investors are generally not on the hook for expenses until they are admitted to the CIV, which typically does not happen until around the time that the deal is consummated. In such a scenario, the co-investors are typically not required to pay a portion of the broken-deal expenses unless they have otherwise agreed to do so (g., as part of an equity commitment letter or other agreement). The allocation of broken-deal expenses is subject to heightened regulatory scrutiny by the U.S. Securities and Exchange Commission (SEC) and should be approached with caution. We will want to ensure we carefully review the GPs policy on how broken-deal expenses will be allocated, and ensure such policy is clearly set out in the applicable governing documents.</p>

<p>Reporting: SCERS will want to clarify its preferred reporting obligations (deliverables and timing) in CIV documents.</p>	<p>We will want to ensure that we have the right to review the CIV's books and records and to receive certain financial records (such as monthly, quarterly and annual financial statements and annual budgets). We will also often see co-investors receive certain portfolio company information (e.g., EBITDA, net debt, net revenues) on an on-going basis. We may also request advance approval of an annual operating budget and material deviations therefrom, although it is not typical to receive this right in CIVs sponsored by GPs. This transparency is critical for NIFO and investment monitoring purposes.</p>
<p>LP Giveback: Pro rata with main fund and including some form of time limitation (e.g. X years from distribution or fund termination).</p>	<p>CIVs are typically permitted to "claw back" distributions from all investors to the extent that the vehicle has insufficient cash to satisfy its indemnification obligations. Typically we will want distributions to be limited in timing (e.g., 3 years after end of fund or 1-2 years from date of distribution) <u>and</u> amount (no more than 30-50% of distributions received by SCERS). Please note that GPs will push back on giving LPs dual protection so we will want to consider the best protection with respect to each co-investment opportunity.</p>
<p>Tax - Structure: Investment vehicle will be respected as a partnership for US federal income tax purposes (e.g. includes other LPs). No requirement for SCERS to invest through blocker or other entity treated as a corporation or pass-through entity without prior SCERS consent.</p>	<p>CIVs have the benefit of flexible structuring so typically managers will be able to provide accommodating structures for co-investors.</p>
<p>Tax - Withholding: GP/manager to use commercially reasonable efforts to provide prior notice of tax withholding and any information reasonably requested to contest.</p>	<p>In addition to their information rights, even in co-investment structures with limited management rights, co-investors will want to have prompt notice rights related to tax issues that may arise, including tax withholding. In some rare instances, co-investors may even negotiate for some input rights with respect to tax controversies – although this tends to be atypical in the co-invest context.</p>

<p>Venue: Substantially identical provisions as SCERS side letter for main fund. If SCERS is not an investor in the main fund, side letter to include acknowledgement that SCERS does not submit to non-local jurisdiction.</p>	<p>Typically GP/manager will agree to venue and governing law mechanics.</p>
<p>Governing Law: Side letter to provide that all California-specific provisions are governed by California law.</p>	<p>Typically GP/managers will agree to venue and governing law mechanics.</p>
<p>Capital Call Notices: At least 10-15 business days to fund.</p>	<p>Although, many times the investment-related capital contributions to CIVs are fully funded upfront, there may be instances where co-investors may be required to fund additional amounts in order to pay fees and expenses that arise -- but those amounts tend to be minimal. This provision will tie into the fee and expense provisions discussed earlier.</p> <p>Note that funding of the initial capital contribution will sometimes be needed immediately upon close, which can create logistical issues.</p>
<p>Permitted Transfers: No GP consent required for whole or partial assignment of interest to a successor entity.</p>	<p>SCERS will need to retain the flexibility to be able to assign its interest to an affiliate vehicle for tax, legal and regulatory concerns. Typically, the GP will seek some standard exclusions here – for example, ensuring that the transferee is under common control – but otherwise GPs tend to be amenable to allowing affiliate transfers.</p>
<p>Amendment to Agreements: SCERS will want to have veto rights to ensure that GP cannot alter deal in ways that disfavor SCERS without its consent.</p>	<p>While most amendments to a CIV's governing documents can typically be made by the majority-in-interest of the co-investors, co-investors will often seek to negotiate the right to block any amendment that would adversely affect certain of their rights or obligations. This may include changes to a co-investor's preemptive, tag-along/co-sale and information rights; giveback obligations; the ability to disclose confidential information to its investors, prospective investors and other parties; any increase in its economic obligations or liability; or any reduction in its right to receive allocations or distributions.</p>

<p>LPAC Representation: If the CIV has an LPAC, SCERS generally expects to have a non-voting LPAC seat.</p>	<p>Usually LPAC seats are assigned based on capital weighting of investors but we will want to push to have an observer seat on an LPAC (if a CIV has one). Many times, the GP will rely on the LPAC of the main fund with respect to conflicts of interest and apply the same decision to the CIV. The risk, as discussed above, is that the interests and composition of the main fund investors are not always aligned with the co-investors. We will need to ensure that in areas such as fees, related party transactions, expense and investment opportunity allocation, that the CIV retains some consent rights while maintaining our limited liability protections.</p> <p>But as noted above, often there is no LPAC for the CIV.</p>
<p>In-kind Distributions: Commercially reasonable efforts for GP to comply with SCERS' in-kind distribution requirements, including for valuation.</p>	<p>Limits on in-kind distributions can typically be achieved similar to the main fund.</p>
<p>Fund Limitations: CIV purposes limited to the co-investment and follow-on investments in the portfolio company.</p>	<p>Sometimes the GP can broaden purpose and power clauses in contractual documents, which provides a gray area for what the CIV is able to pursue. Creates a potential backdoor to use the CIV for other avenues – however, most GPs tend to be amenable to limiting purpose/powers of CIV strictly for investing in the portfolio company and any follow-on investments.</p>
<p>Fund Expenses / GP Overhead: Manager overhead items should not be included in fund expenses.</p> <p>Examples of overhead items include:</p> <ul style="list-style-type: none"> • compensation and benefits of manager employees; • in-house legal, accounting, and back-office compensation or time charges; • rent, IT hardware and software expenses; and 	<p>At times, GP/Managers may use a broad list of expenses that allocates a portion of overhead expenses to the CIV. The best way to mitigate risk is to require the GP to use specificity in listing out expenses of the CIV combined with a cap on operating and organizational expenses. The expense cap puts contractual pressure on the GP to only charge expenses to the CIV that are necessary to the operation and/or organization.</p>

<p>•compliance costs, regulatory filings, etc., other than those specifically relating to the fund or required to operate the fund.</p>	
<p>Removal of the GP: Due to illiquidity of underlying investments, SCERS will need some ability to replace the GP for certain reasons.</p>	<p>A CIV will typically have the same manager and general partner (in the case of a partnership) as the main fund. Most main funds allow for the removal of the manager and/or general partner if a “cause event” occurs and may also provide for a “no fault” removal at the election of a specified percentage-in-interest of the investors. Although some managers will mirror the removal-related terms of the main fund in the CIV’s governing documents, it is more common to provide that if the manager/general partner is removed or resigns from the main fund, they will also be removed or deemed to have resigned from the CIV (although the terms of the CIV may provide that a majority-in-interest or other specified percentage-in-interest can override the automatic removal). It is also common to provide that the main fund’s replacement manager/general partner will also be appointed in a similar capacity to the CIV.</p>



Private Equity Co-Investments

September 15, 2021

SACRAMENTO COUNTY EMPLOYEES' RETIREMENT SYSTEM

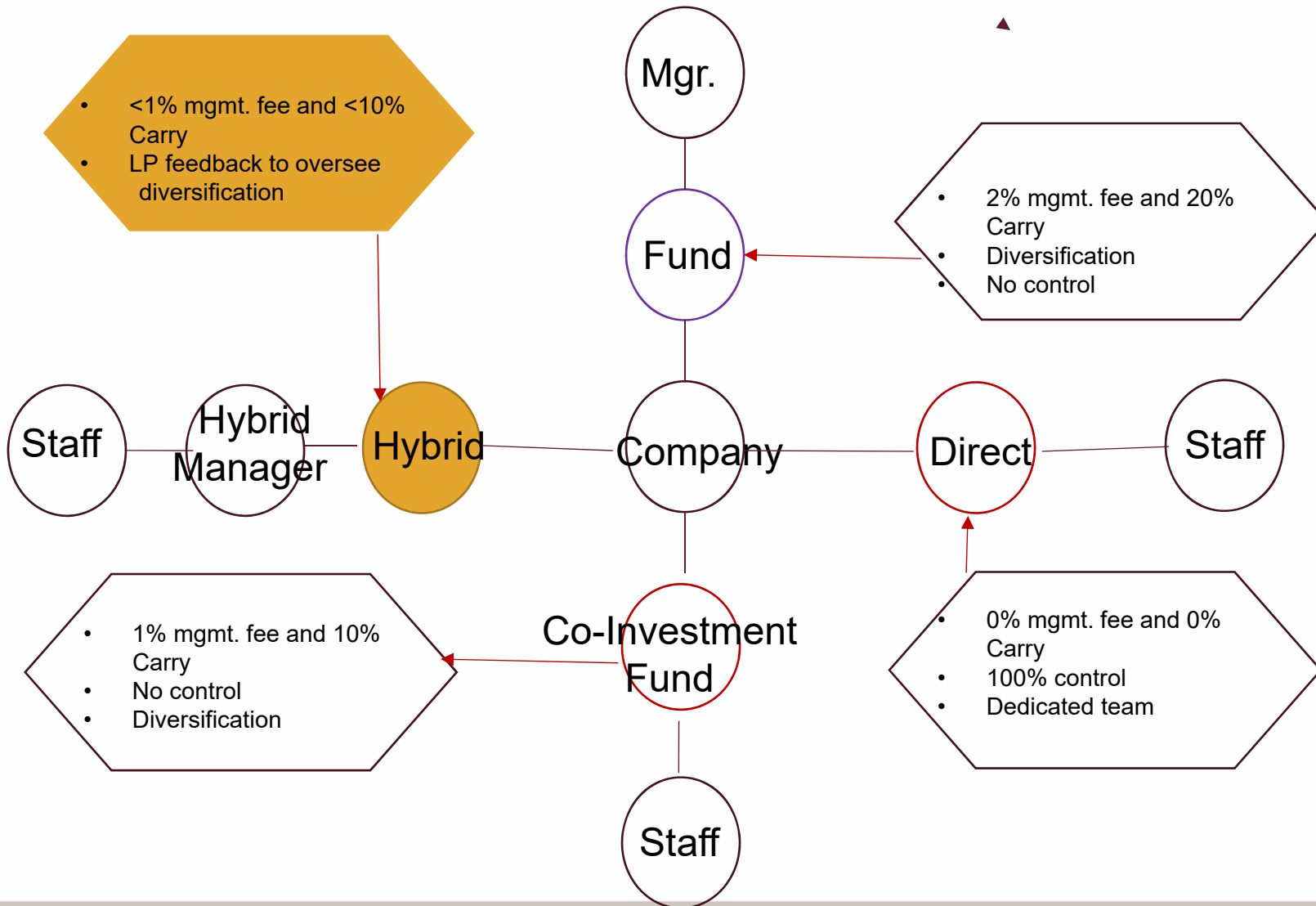
Agenda

- Revisit
 - Summarize the key reasons to invest in co-investments
 - Potential Structures
 - Hybrid Model
- Process
 - Staff's role
 - Underwriting Partners Due Diligence
 - Negative Consent | Veto rights
- Legal Considerations
- Next Steps
 - Expect to issue recommendation
 - Guidelines
 - Terms

Benefits of Co-Investments

- Co-investments are an investment directly into a company alongside a General Partner
- Often a co-investment has better economics than the primary fund
 - 0% fee & 0% is the expectation
- Limited Partners can use this as a tool to increase exposure to a certain sector
- Provides Limited Partners with other insights into the General Partners operations
- Can help endear a Limited Partner to a General Partner if process is straightforward and transparent

Potential Structures



Hybrid Model

- Performance Enhancer
 - Lower fees
- Diversification Tool
 - Target areas of portfolio which may be under represented
- Better Relationship with Managers
 - GPs want a reliable partner when capital is needed
 - Transparency to LPs' process
 - Express interest early
 - See how a GP operates and who is the value driver
- Extended network of Relationships
 - Can use the model to expand potential GP relationships by building connections with GPs outside SCERS primary fund network

Hybrid Model

SCERS

- Number of GP Relationships
 - ±30 GP Relationships
- Annual Investment Pace
 - ±10 Investments
- Number of Full Time Staff
 - 5 People

Partner

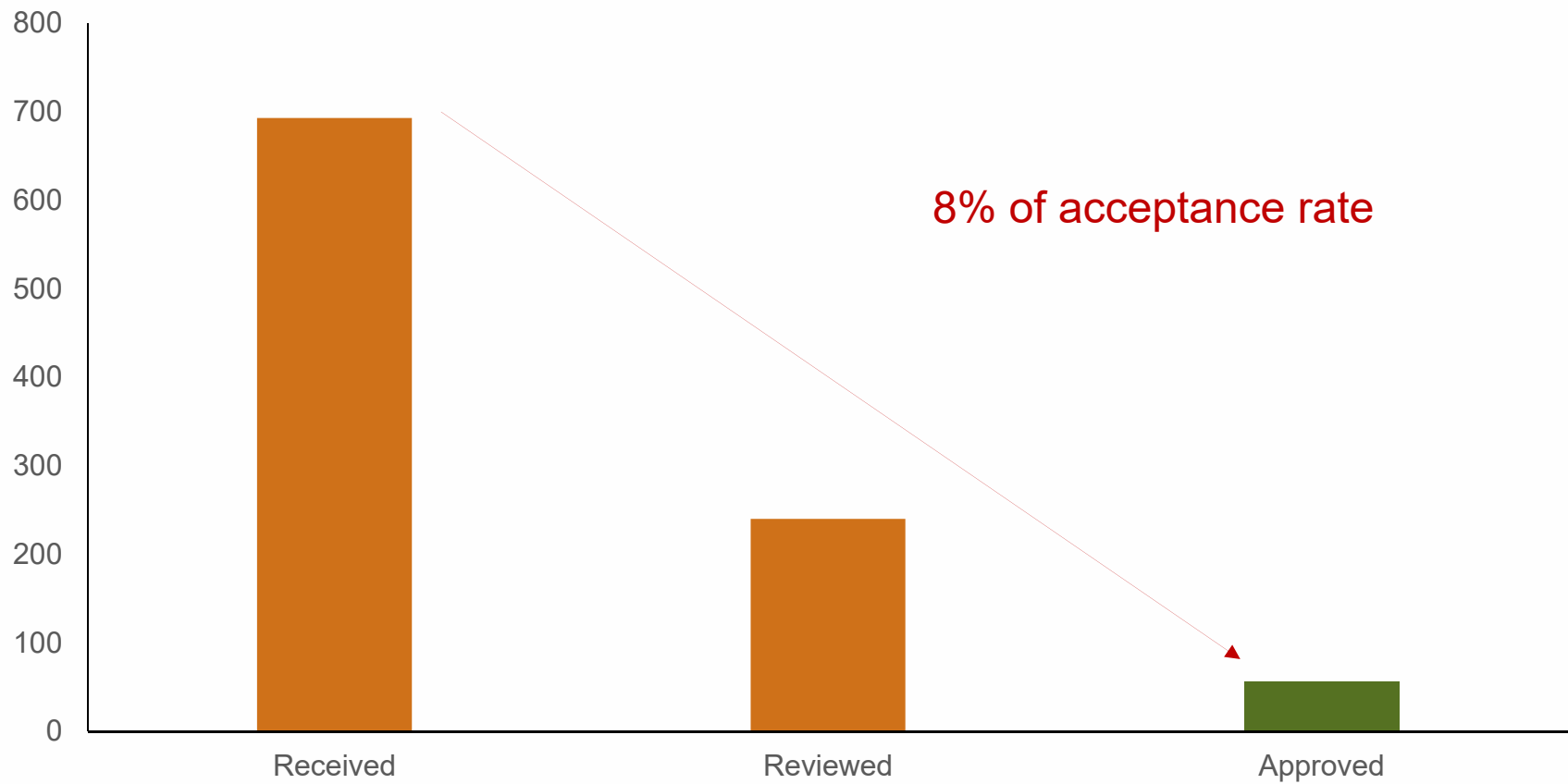
- Number of GP Relationships
 - ± 600 GP Relationships
- Annual Investment Pace
 - ± \$5 billion annually
- Number of Full Time Staff
 - 90 Professionals

Goal:

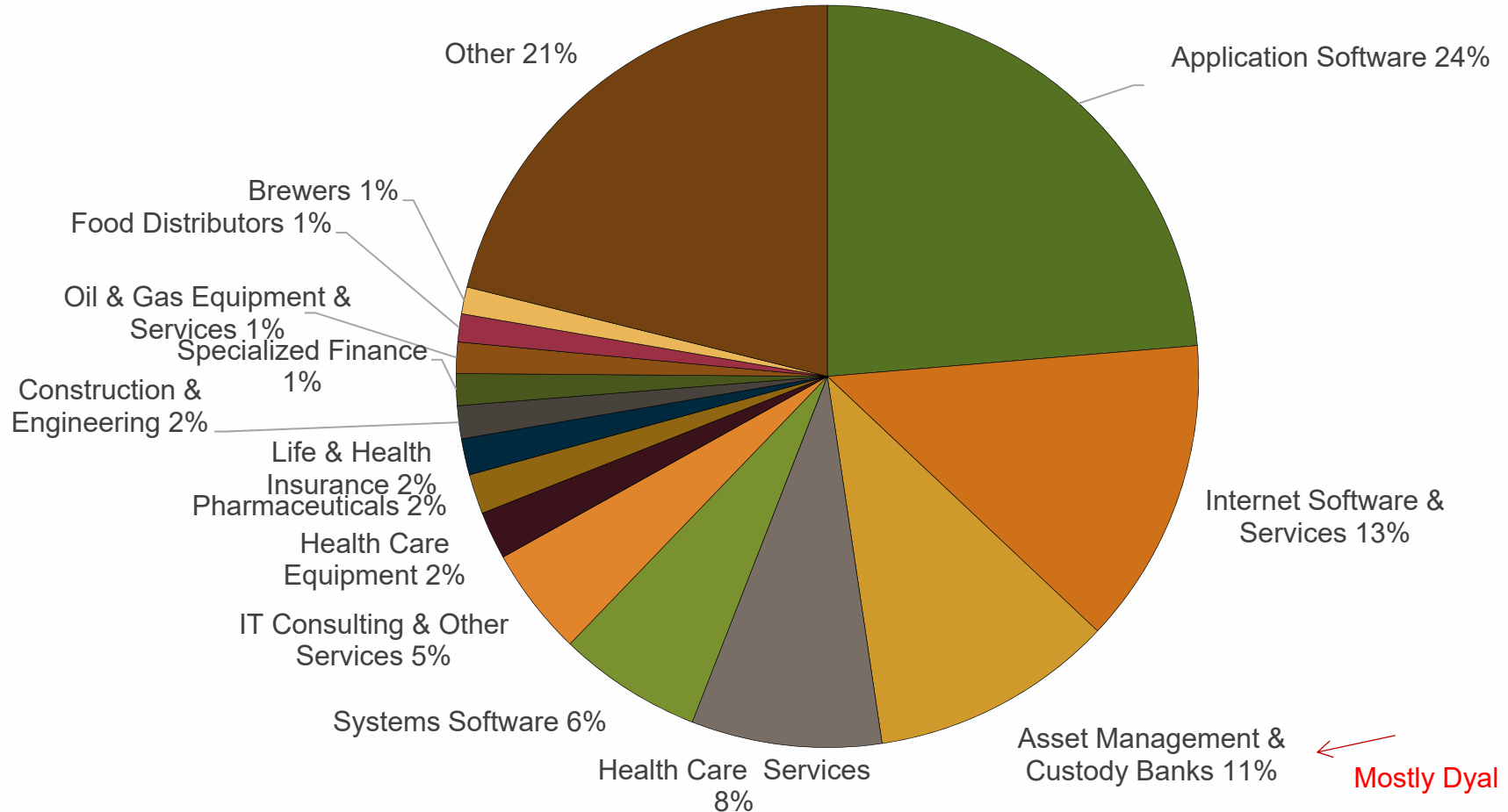
Increase the total number of deals seen

Exercising Judgment is Paramount

Representative Co- Investment Deal Flow



SCERS' Direct Buyout Portfolio*



* Based on 12/2020 data provided by Colmore

Proposed Process

Speed is important but not at the expense of quality

- SCERS and Partner develop a marketing plan to GPs
 - Common messaging
 - Regular follow-up
- Deal flow generation
 - Quick review by Partner
 - Independence of Partner decision making
 - Staff reviews summary document prepared by Partner
 - Staff considers veto
 - Diversification
 - Deal metrics
 - Deal sizing
 - Full underwriting by the Partner
 - Regular communication between SCERS and Partner
- Review final recommendation
 - Negative consent option
- Utilize a LLC, LP, or similar structure

Next Steps:

- Expect to issue recommendation on hybrid partner
 - Group identified
 - Issue recommendation in next three months
- Guidelines
 - Preliminary guidelines have been proposed but not finalized
 - Process
 - Roles
 - Asset class(es)
 - Standard of care
- Terms
 - Below market management fee based on invested capital
 - Below market carried interest with a hurdle rate

Co-Investments – Overview & Key Terms

Presented by:

Thomas A. Hickey, III
Foley & Lardner, LLP
111 Huntington Avenue
Boston, MA 02199
Tel: 617.342.4097

September 15, 2021



Co-Investment Overview

- What is it?
 - PE Co-Investing refers to a process where a limited partner invests alongside a lead financial sponsor (the GP) directly into an investment opportunity/portfolio company, at the same time and on the same terms as the GP's main fund. Typically, a GP will offer co-investment opportunities to LPs invested in the GP's main fund, but not always.
- Benefits of Co-Investing (LP Perspective)
 - Access to handpicked investment opportunities
 - Better fee arrangements (usually no fee, no carry)
 - Accelerate investment pace and allocate dollars to specific areas of interest
- Challenges
 - Investment concentration risk
 - Heightened complexity of structuring considerations
 - Lack of leverage to dictate terms

Co-Investment Challenges

- Meeting SCERS' Fiduciary Duty and Avoiding Fiduciary Liability
 - Prudent Person Standard of Care for alternative assets
 - Ensuring proper review and compliance, without actually managing the vehicle
- Maintaining a Limited Liability Posture to Protect SCERS' Assets
 - Vehicles through which SCERS invests must be limited partnerships or ensure similar protection
 - SCERS must monitor and review activity without jeopardizing that protection
- Speed vs. Quality
 - Deals tend to move very fast – two weeks or less is very common
 - GPs tend to have lots of discretion in offering slots
 - If there is no main fund or other existing relationship, SCERS' leverage to obtain favorable terms may be minimal

Standard of Care Challenges

- SCERS Investment Policy
 - Prudent Person Standard of Care generally required for alternative assets.
 - Co-Investment GPs tend to focus on diluting fiduciary duties – will usually seek maximum exculpation, matching or exceeding what is in the main fund. This will not meet SCERS' preferred standard.
 - Co-Investment GPs likely won't accept SCERS' preferred standard
 - Solution: The Hybrid model. SCERS invests through a fund of one, which invests in Co-Investment Vehicles alongside, and sometimes independent of, SCERS' existing PE funds. The Prudent Person Standard applies at the Hybrid level. **SCERS looks to the manager of the Hybrid entity to take on the role of the fiduciary, complying with the Policy.** (Bonus: The Hybrid Manager will have greater access to deals, and leverage to demand terms, than SCERS alone.)
 - Downside: The Hybrid Manager will require fees and/or carry. This diminishes the economic advantages of the strategy. SCERS must weigh this trade-off:
 - How much are the fees/carry?
 - How strong is the fiduciary commitment?

Standard of Care Challenges

- Practical Challenge: Because these deals are unique, SCERS' will want some degree of oversight and approval rights.
 - But the more discretion SCERS itself has, the more risk that it might be seen as actually managing the vehicle by making investment decisions, which raises two issues:
 - SCERS may not be in the best position to decide. A fiduciary can be obligated to delegate decisionmaking authority, if it lacks the expertise necessary to make the decision at a prudent expert level, or is unable to devote the necessary time and resources to it. See, e.g. Uniform Prudent Investor Act, §9.
 - If SCERS is seen as the decisionmaker, it may be exposed to general liability. This could place at risk SCERS' general assets, rather than just its commitment to the CIV.
 - Solution: NIFO ("Nose In, Fingers Out") i.e. Delegation, Constraints, Oversight and Monitoring
 - What degree of approval right is appropriate, if any? *Negative Consent*.

N.I.F.O. – How Does It Work? (Deals)

- Clear contractual definition of the Hybrid Manager’s authority and limits thereto.
- No deals presented to SCERS unless they meet established guidelines. For example
 - Commitments under \$____,
 - Constitute no more than ____% of the CIV,
 - Within ____ sectors and ____ countries, and
 - Compliant with applicable SCERS policy and legal constraints and requirements. (See slides 9-15)
- A rigorous but fast process:
 - Initial identification of potential deals with a short memo describing the deal. SCERS staff can select those deals to be pursued further. This is *not* a final investment decision.
 - For selected deals, the Hybrid Manager then fully underwrites the deal and, if it has determined it to be an appropriate investment, presents the full package to SCERS.
 - SCERS has approximately a week to veto a deal. The GP has full authority to consummate deals, within established parameters, if SCERS does not veto. (**Negative Consent.**)
 - Deals can be funded through a short-term subscription line, further increasing efficiency.

N.I.F.O. – How Does It Work? (Monitoring)

- Pipeline meetings will occur where SCERS will receive reports of upcoming deals
- SCERS will receive regular reports documenting compliance, with supporting information including legal documentation.
- Full reporting at the Hybrid level, as with any co-mingled private fund.
- Challenge: Will SCERS become the de facto GP? Discipline is crucial.
 - Hybrid Manager must be obligated to bring to SCERS information that it has compiled, to a fiduciary level in terms of vetting and details, per its underwriting and fiduciary duties.
 - The fiduciary role of the Hybrid Manager must be clear in the contract, and adhered to in practice. This will allow SCERS to respond prudently without making SCERS itself the manager of the portfolio.
 - Status and pipeline meetings must not become de facto review and approval sessions. But they, or some equivalent process, must occur - the duty to monitor is a legal mandate. *Tibble v. Edison*, 575 U.S. 523 (2015).

Ensuring Liability Protection within the Hybrid CIV Structure

- The Hybrid itself must be a limited liability vehicle (LP or LLC), with adequate assurance of protection of SCERS from liability for the vehicle's actions.
- The Hybrid Manager's fiduciary duties must be subject to a "Section A" standard of care.
- The Hybrid Manager's fiduciary duties must cover the manager's main functions - sourcing and underwriting deals and making investment decisions.
- SCERS' counsel (General Counsel and investment counsel, cooperatively) must make an assessment of the Hybrid overall adequacy of the protections, based on the aggregate strength of these and other that may apply.

Hybrid Entity with N.I.F.O. – Advantages

- Complies with Standard of Care Policy, which might not otherwise be achievable in co-investments.
- Permits SCERS to review deals, without making it the manager of the fund and exposing SCERS' corpus to potential liabilities.
- Pre-set guidelines and legal constraints, and a negative consent process, mean fast access to deals – a must in the co-investment space.
- Streamlined process gives SCERS access to the Hybrid Manager's deal flow, as well as that of its existing managers.