



# Board of Retirement Regular Meeting

## Sacramento County Employees' Retirement System

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### Agenda Item 21

**MEETING DATE:** April 20, 2022

**SUBJECT:** Private Equity Secondary Sales: Education and Implementation

**SUBMITTED FOR:** \_\_\_ Consent        X   **Deliberation and Action**      \_\_\_ **Receive and File**

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Staff recommends the Board take the following actions:

1. Receive and file the education presentation on secondary sales within the private markets;
2. Authorize Staff to select and retain an advisory firm to lead a secondary sales process for Fund of Funds investments in the private equity portfolio; and,
3. Direct Staff to make conforming changes to the implementation protocols in the asset category Investment Policy Statements.

#### **SCERS' PRIVATE EQUITY PORTFOLIO:**

Over the past few years, private market investments have performed exceptionally well relative to other asset classes, which has led to SCERS' Private Equity portfolio becoming overweight to its newly revised 11% target allocation, with an allocation of 13.4% as of December 31, 2021. The increase in the allocation has been significant, as SCERS' Private Equity allocation was 9.1% on December 31, 2019, and 10.1% on December 31, 2020. Despite the current overweight, Staff and SCERS' alternative assets consultant Cliffwater believe it is important to continue to commit to funds according to the annual budget for Private Equity and Cliffwater's capital pacing models, which show that SCERS' Private Equity allocation will reduce toward the 11% target allocation over the next 18 months. Staff and Cliffwater also believe that utilizing the secondary market to potentially sell stakes in legacy funds that do not have a strategic place in SCERS' Private Equity portfolio can play a part in managing SCERS' Private Equity allocation around its target allocation.

#### **SECONDARY MARKET:**

At their core, secondaries involve buying and selling private market assets by either a limited partner (LP) like SCERS or a general partner (GP). Dedicated private market secondary funds have existed since the mid-1990s and are a mature asset class comprising dozens of groups

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that raise billions of dollars. Large secondary funds that participate in secondary markets have hundreds of funds in their underlying portfolios and exposure to thousands of companies.

The volume of secondary deals continues to increase each year. Although the transactions between GPs are growing, secondary funds primarily are focused on the acquisition of LP positions. Competition for deals also has increased with the number of secondary firms increasing and the availability of capital. According to Evercore, secondary firms have more than \$100 billion in unallocated capital available to buy secondary positions and this number is expected to increase by an additional \$70 billion in 2022. When available capital is coupled with leverage, a key component of many trades, ample capital becomes available to fund the secondary market for the next few years.

### **WHY AN LP MIGHT WANT TO SELL:**

Many primary fund investors regularly utilize the private secondary market as an ongoing portfolio management tool within a mature private equity program. Sellers of assets in the secondary market are motivated by a host of reasons, including:

- Portfolio maintenance and opportunity: There is not a necessity to sell, but the LP will sell at the right price.
- Portfolio rebalancing: Because private market assets are illiquid by design, a sale can be helpful to comply with an investment policy target allocation. .
- Sellers in financial distress: the organization has financial needs and is looking to sell assets to cover issues at the organization level. The seller may need to trade good assets with bad to generate liquidity.
- Overextended sellers: Some newer LPs have overcommitted to catching the boom in the private market. Although this is an effective strategy, the time may come when an LP does not have the cash to pay capital calls, such as during a distressed or dislocated period in the markets. For example, during the global financial crisis, some LPs implored GPs not to make capital calls for fear of not having enough liquidity in their portfolios to meet them.

Staff and Cliffwater believe it is time to explore selling assets in the private market portfolio as part of a regular maintenance plan and as a potential rebalancing tool.

### **DETERMINATION OF PORTFOLIO ASSETS—SCERS MIGHT LOOK TO SELL:**

Regardless of the motivations behind an investor's decision to sell, obtaining the highest price is the optimal goal. Staff and Cliffwater will consider the following factors when determining which potential private markets portfolio to explore selling:

- No longer active in the segment: SCERS entered private markets in 2006 by investing in highly diversified but higher-costing Fund of Funds (FoF) – a portfolio that contains different underlying portfolios of other funds. Since 2010, SCERS has implemented a direct fund investment strategy, where SCERS invests directly with funds to gain

access to private market funds. A direct approach has delivered returns above SCERS' private equity policy index benchmark and long-term private equity return assumption.

- Lock in performance of funds: SCERS has benefited from exceptional performance from many of its GPs, as measured by internal rate of returns (IRR) and multiples of invested capital (MOIC), with outsized performance across a number of underlying buyout, growth equity, and venture capital funds. Potentially utilizing the secondary market to sell SCERS' position in some of these funds provides an opportunity to lock in and realize these gains.
- Inactive relationship: There are several GPs in SCERS' Private Equity portfolio where SCERS is no longer investing in subsequent funds of the GP. This is due to a combination of factors. For instance, a GP may be unwilling to comply with evolving California disclosure requirements or SCERS policies, or there are organizational or performance issues with the manager. In these circumstances, SCERS could explore selling its stakes in these legacy funds where SCERS doesn't anticipate investing with the GP in the future.
- Age: Although most private market funds have a natural life of 10 to 12 years, some funds extend beyond the stated life of the fund. At some point, without a clear path to final liquidity, it is common for LPs to go through a clean-up process wherein the opportunity cost to hold the investment is outweighed by a better use of capital to reinvest proceeds in a new fund. Although SCERS does not have any funds that meet this criteria, this may occur in the future.

	<b>Fund Count</b>	
Long Term Hold	50	Staff and Cliffwater have examined the portfolio of SCERS' private equity funds, and believe that there are approximately two dozen funds that fall under the categories above. Staff and Cliffwater believe that the focus at this time on funds to consider selling in the secondary market should be the legacy FoF positions that SCERS invested in 2006-2008. Funds under consideration include
Lock In Returns	7	
No Longer Active In Sector	6	
Inactive Relationship	11	
<b>Grand Total</b>	<b>74</b>	

FoFs from HarbourVest Partners, Abbott Capital, and Goldman Sachs.

As of December 2021, the Private Equity allocation represented approximately 13% of plan assets. Selling these FoF positions would help bring SCERS' Private Equity allocation closer to the 11% target allocation by reducing the Private Equity exposure by 1%. An initial transaction will also help the Board, Staff, and Cliffwater become comfortable with the secondary process and serve as a foundation for future secondary sales, including potential sales within the other categories above. Other sales could happen at a later date but Cliffwater's capital pacing models show that SCERS' Private Equity allocation will reduce toward the 11% target allocation over the next 18 months without any secondary sales.

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## **IMPLEMENTATION PROTOCOLS:**

SCERS invests in private market assets under Board policy – Investment Policy Statements – that delegate authority to Staff to select investment managers unless the Board objects. The Investment Policy Statement for Private Equity, and other private market asset classes, also identifies and envisions secondary purchases and sales as part of managing and rebalancing the portfolio. While SCERS has purchased secondary assets under current practice, SCERS has not yet sold secondary positions.

Staff recommends using the current implementation protocols for the alternative assets/private market asset classes to implement private market secondary sales, with one addition – adding authority for Staff to retain a specialized investment advisor to facilitate the sale.

The updated implementation protocol would entail Staff and Cliffwater determining which funds to consider in a secondary sale, and recommending an advisor to assist in intermediating the transaction. The implementation protocol includes Staff preparing an Initial Report, which will highlight which fund(s) are under consideration for a secondary sale, and why they are under consideration. The Initial report will also highlight the recommended intermediary/advisory firm, the terms of intermediary, initial pricing, and expected timing.

Later in the process, Staff will prepare a Final Report, which will include a legal review of documents associated with the secondary sale, final pricing, the expected timing of the contract, and the timing of cash flows. Cliffwater will also prepare a Statement of Concurrence. The Board would be updated upon the final closing of the secondary sale transaction.

## **PRIVATE EQUITY SECONDARY ADVISOR**

A common approach to executing a private market secondary sale is with the assistance of an advisor, typically an investment bank. Staff and Cliffwater believe that SCERS' private equity portfolio has reached a maturity level that warrants the help of an advisor to examine potential funds to consider in a secondary sale. Staff has met with three well-respected groups to analyze value expectations and pricing. With a mixture of funds of funds, buyouts, and venture capital funds within the aggregate Private Equity portfolio, any secondary sales are likely to be split into pieces rather than sold in a single transaction.

Staff recommends that the Board authorize Staff and Cliffwater to select an advisor to assist in selling SCERS' legacy FoFs portfolio. Staff and Cliffwater will work with the preferred advisor to build a portfolio of funds that will maximize SCERS' return. The advisor will be compensated on a contingency basis. The process will take six to nine months to complete. Additional costs for the transaction will come from hiring a third-party legal firm (consistent with current practice), which will need to review legal documents; hiring an outside data room provider; and transferring the assets to the new owner.

Pricing on the secondary market is often an auction market with pricing determined by the underlying holdings. Initial pricing indications for SCERS' FoFs portfolio suggest a 15-20%

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discount to Net Asset Value (NAV). Staff believes the funds in this portfolio have minimal upside remaining given that they are vintage year 2006 and 2008 funds. Since inception, they have generated a net IRR of 12.6%, which significantly trail the net IRR of 24.7% that SCERS' direct fund investments have generated since 2010.

**NEXT STEPS:**

Staff and Cliffwater will identify an advisor to evaluate selling SCERS' legacy portfolio of private equity fund of funds. Staff will report to the Board the proposed portfolio, advisor, and pricing. If approved, this transaction is expected to close in the second or third quarter of 2022.

SCERS' investment policy statements are scheduled to be updated over the next couple of months and presented at the June Board meeting. The updated IPS will include language to update the proposed process and implementation protocols for secondary investment sales.

**ATTACHMENTS:**

- Board Order
- Staff and Cliffwater Secondary Sales Presentation

Prepared by:

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Jim Donohue  
Deputy Chief Investment Officer

/S/

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Steve Davis  
Chief Investment Officer

Reviewed by:

/S/

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Eric Stern  
Chief Executive Officer



# Retirement Board Order

## Sacramento County Employees' Retirement System

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Before the Board of Retirement  
April 20, 2022

AGENDA ITEM:

### Private Equity Secondary Sales: Education and Implementation

THE BOARD OF RETIREMENT hereby accepts the recommendation of staff to receive and file the education presentation on secondary sales within the private markets; authorize staff to select and retain an advisory firm to lead a secondary sales process for Fund of Funds investments in the private equity portfolio; and, direct staff to make conforming changes to the implementation protocols in the asset category Investment Policy Statements.

I HEREBY CERTIFY that the above order was passed and adopted on April 20, 2022 by the following vote of the Board of Retirement, to wit:

AYES:

NOES:

ABSENT:

ABSTAIN:

ALTERNATES (Present but not voting):

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Richard B. Fowler II  
Board President

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Eric Stern  
Chief Executive Officer and



# Retirement Board Order

## Sacramento County Employees' Retirement System

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Board Secretary



# Secondary Sales

The Next Evolution for Mature Private Equity Portfolio

April 20, 2022



# Agenda

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- Growth in SCERS' Private Equity portfolio – overweight target allocation
- Education on secondary investing within the private markets
  - When to consider and how funds are chosen
- Recommend Board authorize Staff to select and retain an advisory firm to lead a secondary sales process for Fund of Funds investments in the private equity portfolio
  - Will assist in bringing SCERS' Private Equity portfolio closer to target
  - Hiring an advisory firm will facilitate a competitive process and aid in maximizing the price
- Sales process - timeline, procedure, pricing

# Performance Over Last Year (period ending 6/30/21)

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- Per Colmore: Private Equity Performance is up over 50%.
- Eight funds had IRRs in excess of 100%
- Distributions outpaced capital calls by approximately \$85 million in 2021
- Performance was driven by increased valuations in the venture and growth portfolios that were driven by the public markets
- Funds of funds had a strong year as well with all funds barring one had IRRs in excess of 40%. The funds of funds had an inception-to-date IRR of 12.3%
- Eleven funds have net multiples over 2.5x and IRRs in excess of 20%

# Private Equity Exposure

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- The portfolio value is \$1.8 billion as of December 2021, or 13.4% of the plan versus the 11% target allocation.
  - \$318.2 million above target
- Important to consistently commit to funds according to the annual budgets and Cliffwater's capital pacing models
  - Cliffwater's pacing model has the PE portfolio reducing to the target allocation by the end of 2023 or early 2024
- Secondary sales are an additional portfolio management tool

# Secondaries Defined

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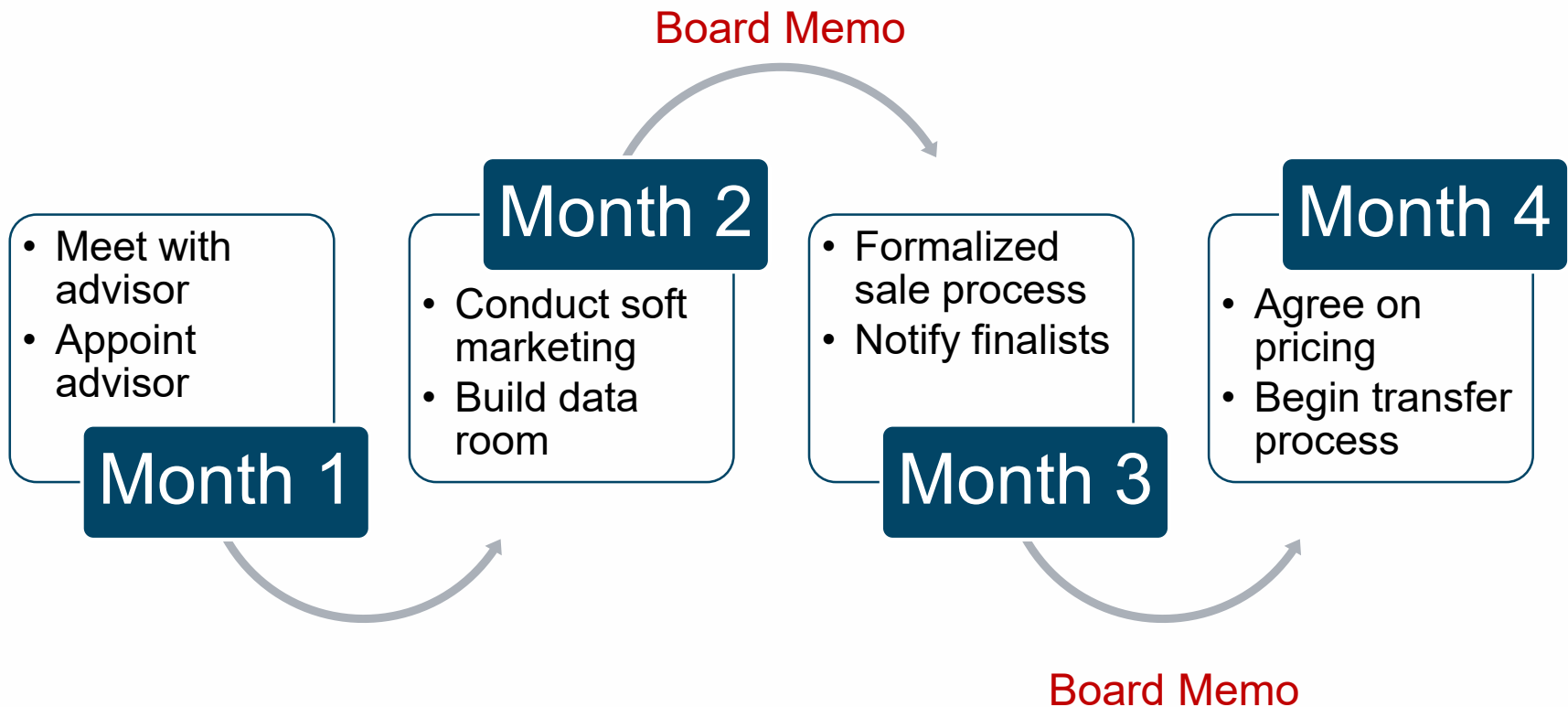
- Private-equity secondary market (also often called private-equity secondaries or secondaries) refers to the buying and selling of preexisting investor commitment
- Many investors utilize the private secondary market as an ongoing portfolio management tool within a mature private equity program
- Despite the pandemic that slammed markets of all kinds in 2020, it was the second busiest year ever for secondaries, with a volume of \$71 billion. That's down just 14.5% from 2019's all-time record of \$83 billion
- There are large amounts of uncalled capital in the secondary market. In 2001, \$4 billion was raised, and in 2020 \$94 billion was raised

# How Funds Are Chosen

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- Every three years, Staff and consultant should carry out a review of funds in the private market portfolio
  - Time frame between reviews is a guide not a rule
- The following are reasons to sell an LP holding:
  - No longer active investors in sub strategy
  - To crystalize performance
  - The age of the underlying fund
  - A continued GP relationship is not forecasted
- Staff and the consultant should review the list of funds and add or subtract funds based on their knowledge of the portfolio such as GP forecasting exits or of potential valuation changes

# Sales Process



# Selling Illiquid Assets

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- Provide a list of funds to an advisor for pricing
  - Given the large number of groups performing these services, Staff and consultant recommend going to a select group of advisors
- The pricing of the transaction is based on a premium or discount to the value at a designated reference date
- The price for the advisor's services is typically a percentage of the cash transferred
- Standard legal costs will occur
- Current GPs will have a role in the process
- Bidders may bid on parts of or the whole portfolio

# Selling Illiquid Assets (Cont.)

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- Bids will typically come in two ways:
  - All cash
  - Cash and deferred payment
    - Typically, this option lowers the discount
- Once a deal is agreed upon, significant paperwork is generated as the relationship is transferred from SCERS to the buyer
- At a transfer date, SCERS will no longer be the owner, and cash will be sent to SCERS
  - SCERS will no longer hold assets or receive reporting
- The process can take six to nine months or longer



# Procedure

- Staff and Cliffwater request the Board approve hiring an advisor to market and potentially sell the legacy funds of funds
- The advisor will take the list of funds out for soft marketing and present the results to Staff and consultant
- Following alternative assets/private market implementation protocols, Staff will inform the Board which funds are recommended to be sold, why these funds were chosen, and estimated pricing
- Advisors and Staff will build a data room for the collection of due diligence materials
- Advisors and Staff will request final bids
  - If a fair price is not received no sale will occur.
  - Staff will inform the Board of the final price prior to executing a Sales and Purchase Agreement

# Procedure (Cont.)

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- Concurrently, the investments being sold will be marked down by State Street, Cliffwater, and Colmore to the sale price
- Staff will work with advisor to get assets transferred
- When the handover is complete, capital will be sent by the winning firm(s) to SCERS
- After completion of the sale, Staff and Cliffwater will do the following:
  - Evaluate the sales process and the advisor

# Next Steps

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- Direct Staff to hire an advisory firm to evaluate and run an auction process for the sale of the legacy Private Equity funds of funds portfolio
  - Assuming rational pricing is attained
  - Follow alternative assets implementation protocols
- Staff will also evaluate if additional secondary sales are warranted in other parts of the Private Equity portfolio
  - i.e., direct funds
- Direct Staff to make conforming changes to the implementation protocols to the investment policy statements to incorporate secondary sales

# Common Questions

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- What are estimated proceeds?
  - \$70–\$100 million, it is important to note there have been \$30 million in distributions since September 30
- Why is SCERS selling private equity assets now?
  - A secondary sales process is a natural part of a mature portfolio
  - Selling will bring the asset class closer to its target allocation
  - Cash will be used to rebalance other segments of the total portfolio
- What if prices do not meet expectations?
  - SCERS would pull the opportunity. The only costs incurred would be for limited legal costs and the data room