Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 19

MEETING DATE: **April 17, 2019**

SUBJECT: **Future Implementation Considerations for SCERS' Private Equity Portfolio**

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

RECOMMENDATION

Staff recommends the Board receive and file the presentation on future implementation considerations for SCERS' Private Equity portfolio.

PURPOSE

This item supports the 2019 Annual Investment Plan to provide education to Board members about private equity investment strategies.

SUMMARY

While SCERS has utilized secondary investments and co-investments in the past, Staff and Cliffwater believe SCERS' Private Equity portfolio is reaching the level of maturity and sophistication to warrant greater incorporation of these tools to more effectively manage the portfolio and potentially enhance returns.

With a strong portfolio of over 50 investments in the Private Equity asset class, SCERS has experienced strong aggregate returns across the portfolio, though some funds have been more accretive to performance than others. Staff and Cliffwater believe that a well thought out approach to secondary investments could allow SCERS to explore selling some non-strategic private equity positions on the secondary market, while also utilizing the secondary markets to buy single fund positions in managers where SCERS can generate high returns with a greater level of transparency to the underlying fund's portfolio. With SCERS' investment team being fully staffed, secondaries are an effective tool for portfolio management and a means to enhance returns.

SCERS has an active roster of managers in its Private Equity portfolio across strategies and sizes. At times, these managers need additional capital to invest in a company and therefore seek co-investments from their underlying investors. Co-investing alongside a General Partner

(GP) is not a new concept, but has been around for a long time helping some Limited Partners (LPs) narrow the gap between gross and net investment returns. By taking a passive stake in an investment alongside a GP in a transaction, the LP typically will not pay a management fee or carried interest on that direct investment. Although higher on the risk curve, co-investments made alongside core primary private equity investments can be a valuable tool to enhance returns.

There is no action required by the Board at this time. This presentation is designed as the first step in the educational process to assist the Board in becoming more familiar with these two tools. Secondary investments and co-investments can also be utilized in other private market asset classes, including non-core real estate, real assets, and infrastructure.

BACKGROUND

SCERS' Private Equity asset class resides within the Growth asset category and comprises a 9% target allocation within the SCERS portfolio. SCERS' current allocation to Private Equity (as of December 2018) is 9.1%. The Private Equity portfolio is comprised of sub-allocations to various categories, including buyout, venture capital, distressed debt, and 'other' strategies that don't fit neatly into the other categories.

SCERS Private Equity Portfolio Construction			
	Minimum	Target	Maximum
Total Private Equity Portfolio	7%	**9%**	11%
U.S Focused			
Buyout	30%	**50%**	70%
Distressed Debt	0%	**10%**	20%
Venture Capital	10%	**20%**	30%
Other	0%	**0%**	15%
Non-U.S Focused			
Buyout	10%	**15%**	20%
Distressed Debt	0%	**2%**	10%
Venture Capital	0%	**3%**	10%
Other	0%	**0%**	5%

SCERS first began investing in private equity in 2006 and 2008, through generalist fund of funds (FoF) investments. A FoF is a fund that invests in a portfolio of underlying funds rather than directly into companies. The underlying funds in a FoF then invest directly into companies. An objective of a private equity FoF is to achieve broad diversification across some strategies and private equity funds, and is often used by smaller investors who seek to avoid concentrated exposure across funds and managers. FoFs often uses secondaries and co-investments as a means to shorten the J-curve and improve net returns. SCERS committed $238 million to four FoFs[1] with three GPs in 2006 and 2008. These funds have a blended IRR of around 11%, below the long-term SCERS Private Equity performance of 14.6%, as of September 2018. FoFs represents approximately 17% of the private markets portfolio as of September 2018. FoFs' dominance in the portfolio is declining as a result of distributions from the managers and growth in other parts of the portfolio.

In 2011, SCERS engaged Cliffwater as a dedicated alternative assets consultant, and part of this engagement was to assist SCERS in building out a direct Private Equity portfolio, by transitioning from utilizing private equity FoFs to investing directly in private equity limited

[1] HarbourVest VIII is made up of three underlying investments but is counted as one for the purposes of this exercise

partnerships. Since 2011, SCERS has established relationships with 20 private equity general partners (GPs) and invested across 47 limited partnership funds, excluding the 2006 and 2008 FoFs. Over this period, SCERS has exclusively invested directly with specialist private equity partnerships, with the exception of a commitment in 2018 to RCP Fund XIII, a specialist FoF, which invests in small buyout funds, a part of the market that SCERS cannot efficiently access. Other SCERS FoF mandates are an Absolute Return program with Grosvenor Capital Management and in the Real Assets asset class a partnership with Pantheon Ventures.

SCERS' direct approach to private equity has been successful with strong returns on an absolute and relative basis. As of September 2018, SCERS' total since inception Private Equity net internal rate of return (IRR) was 14.6% versus the policy index benchmark (Cambridge Associates Global Private Equity and Venture Capital pooled IRR) return of 13%. The total net value to paid in capital (TVPI) was 1.48x. These returns are strong, especially considering that SCERS' Private Equity portfolio is earlier in its investments cycle (J-Curve impact) and is less seasoned than the benchmark. Over the 3-year and 5-year periods, SCERS' Private Equity portfolio has generated a net IRR of 18.2% and 17.1%, respectively, versus the policy index benchmark net IRR of 14.5% and 14.3%, respectively.

SCERS reached its target allocation of 9% to Private Equity in 2018. While returns have been strong on an absolute and relative basis, there are considerations in managing a maturing private equity portfolio and maintaining the target allocation. These include the number of managers and funds in the portfolio and the increasing level of management fees and accrued carried interest within the portfolio. Secondaries and co-investments are portfolio management tools that can potentially assist SCERS with more efficiently managing the Private Equity portfolio, and enhancing already strong investment returns.

The SCERS Growth asset category investment policy statement (IPS), in which Private Equity is a component, allows for secondary and co-investment investing alongside primary investments in private equity funds. Secondary investments or co-investments are not considered separate investment strategies within private equity, and therefore can be included in any of the private equity categories, including buyout, venture capital, or distressed.

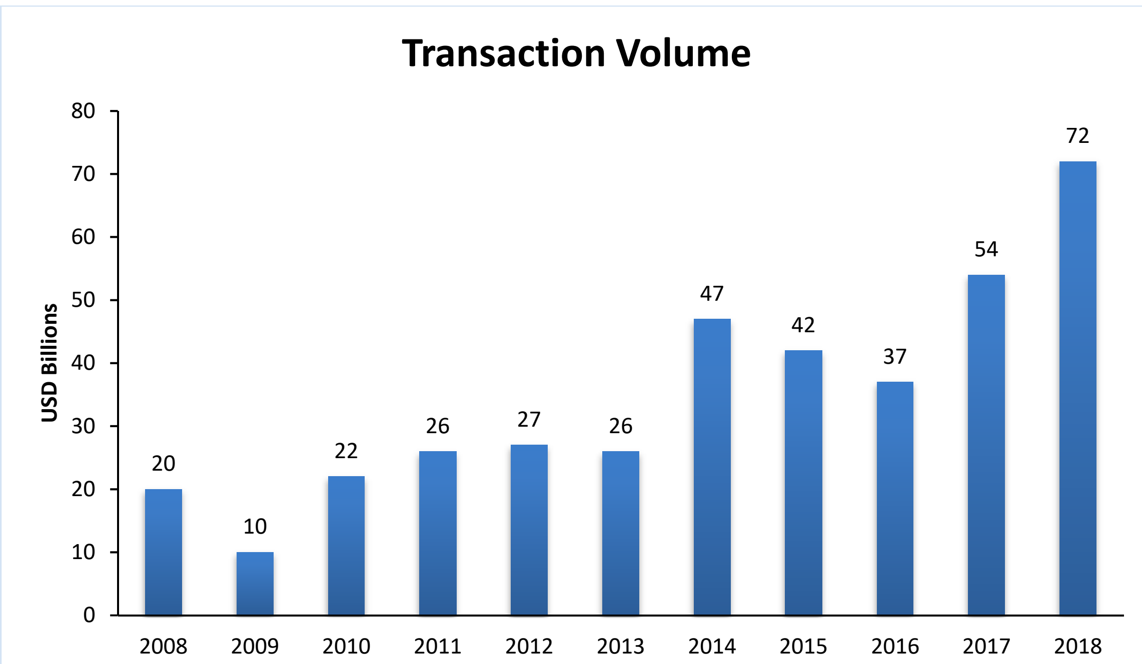
SECONDARIES

Private equity fund commitments are illiquid investments with 10-12 year fund structures. Secondaries are the buying or selling of single funds or portfolios of funds from LPs seeking early liquidity. An attractive feature of secondary investments is the ability to view and underwrite the underlying portfolio, which differs from a primary fund investment in which LPs enter into a blind pool of investments. Since much of the investment period is complete when a secondary investment is made, underlying investments are often yielding cash flow or are closer to an exit, therefore mitigating some of the J-Curve associated with private equity funds. Also, secondary investments are commonly purchased at a discount to net asset value (NAV), which can further enhance returns across all private equity.

Staff and Cliffwater believe SCERS' Private Equity portfolio has matured to the point where an ongoing review of the portfolio should be performed to determine if any underlying SCERS funds should be candidates for sale in the secondary markets, as well as staying informed of secondary opportunities to purchase with the funds of high conviction managers. Selling or buying private equity positions within the SCERS portfolio would be time sensitive and resource heavy but has been a mutually beneficial tool for market participants over the last 10 years in an asset class that is inherently illiquid.

With the growth of fund of funds also came the development of dedicated secondary funds, and while these secondary funds have been around for over 20 years, 2010 marked the beginning of the golden age for secondaries as an asset class and tool for portfolio management. Annual fundraising volume for secondary funds averaged just under $9 billion from 2000 to 2011, according to Preqin, but since 2012 annual fundraising has taken off, with an estimated $60 billion expected to be raised in 2019. The amount of capital raised when combined with the leverage (used to generate returns) results in an estimated $230 billion available for new investment. The fundraising boom was matched with a spike in the volume of deals. According to the investment bank Evercore, the 2018 volume of transactions was over $72 billion (See Chart 1). Even with a spike in volume, there is an estimated three years of dry powder in the market.

Chart 1



The definition of secondary has changed dramatically over the last 20 years. While the buying and selling of fund positions still occur, the definition of a secondary has also loosened. In a rush to deploy large funds, secondary managers are broadening the definition of “secondary” to include buying GPs that can no longer raise funds, delisting holding companies, restructuring older funds, buying co-investment positions, as well as a host of other investments. Almost every year the secondary market seems to come up with a new type of asset to buy so they can deploy their larger funds. The bull market of the last 10 years has resulted in strong returns for a number of these managers, but the use of leverage in transactions means that a prolonged downturn in the market could have a demonstrable impact on their returns.

With the growth in secondaries, many established secondary managers are leaving a market opportunity to acquire single fund positions because they are just too small. One secondary fund manager commented that they prefer deal sizes over $800 million across the top 21 buyers. In 2018, the average deal size was over $250 million, according to Evercore. While these large groups dominate the headlines, there is an opportunity for SCERS to operate at the periphery, buying single positions in managers where there is a high conviction.

Sellers of primary positions on the secondary market may occur for a large number of reasons including reducing unfunded commitments, removing underperforming managers, reducing GP count, locking in the performance of a stellar fund, as well as a host of others. Smaller single manager/fund transactions can be sourced through GP relationships, intermediaries, or the personal networks of Staff and Cliffwater. These transactions often are not as competitive and/or time sensitive, and there is anecdotal evidence that they may not be as price sensitive as well.

Staff and Cliffwater believe the best approach to selling positions would be through the intermediated market, but if SCERS were to acquire positions, it would be best to do so outside of the intermediated market. While SCERS will not be a large buyer or seller of secondaries, they could be an effective way to manage a portfolio that has a growing number of managers as well as a means of increasing exposure to higher conviction managers. Before selling positions, a full bottom-up approach would need to be performed on the portfolio with attention focused on funds which are underperforming on both an absolute and relative basis. An ongoing formal review of all investments would allow Staff and Cliffwater to determine if a portfolio of assets could potentially be put up for sale to maximize pricing.

Through a detailed portfolio review, Staff and Cliffwater can build a list of core high conviction relationships within SCERS' existing Private Equity portfolio. These are groups where Staff and Cliffwater believe the GP has been de-risked and SCERS would potentially seek increased exposure to the GP and the underlying investments through the secondaries markets. As a second step Staff and Cliffwater would develop a "buy" list of managers and proactively target GPs, which is similar to the way Staff and Cliffwater target primary opportunities. Staff recommends that SCERS only make a secondary investment where a primary relationship is forecasted. These GP friendly transactions may not have the highest discounts or volumes, but allows SCERS to get to know the GP better through a potentially valuable fund investment.

Cliffwater and Staff agree that secondary investments or sales will never be a large part of private equity strategy but operate at the margins. A well-executed sale even at a discount could free up capital to invest in higher performing assets. Careful acquisition of mature assets, whether they be a buyout or venture fund, could result in better cash flows and performance for the entire Private Equity portfolio.

CO-INVESTMENTS

The primary objective of a private investment program is to deliver a significant return driver to the total portfolio, and the purpose of co-investing is the same. Co-investing is a decision to deploy capital into a single asset alongside a GP, with the range of outcomes for individual co-investments wider than for fund investments. Co-investments are attractive because they are characteristically offered to LPs at favorable terms and fees. These single company commitments can include zero management fee and zero carried interest. Return expectations for co-investments are higher than that of primary fund investments making them an attractive component of a mature private equity portfolio. Similar to secondary investments, co-investments can reduce the impact of the J-Curve and improve net returns. Cambridge Associates data illustrates that there is an average 725 basis point difference for primary fund investments between gross and net returns, and contends that a well-executed co-investment program can significantly reduce the gross to net performance gap.

Defining a co-investment program's objectives, and the metrics used to judge them, are crucial to its success. Target objectives may include: net return enhancement, cost reduction, increasing exposure to specific sectors, and reinforcing core GP relationships. The market opportunity is significant, with Cambridge Associates estimating that $60 billion in co-investments were offered to LPs in 2017.

There are numerous ways an LP may get exposure to co-investments. Many funds of funds have taken the deal flow from their core business to raise dedicated co-investment funds. These funds typically charge a 1% management fee and a 10% carried interest. Ignoring the conflicts of interest between the two strategies, it can be challenging to understand why the manager deserves compensation at that level given the more passive nature of the investment.
Another way an investor may construct a co-investment program is a direct approach similar to how a GP typically structures a fund—follow predetermined exposure limits and invest over a multi-year time horizon. These exposure limits may incorporate size, strategy, sector, geography, and risk/return profiles, among other specific factors. Another way an investor might construct a portfolio is to judge each investment on its own merits and size the investments relative to each opportunity.

Co-investment opportunities typically have a tight deadline, so it is essential that an effective program has sufficient resources dedicated to underwriting opportunities. One approach SCERS could take in structuring a co-investment program is working with an external manager to help underwrite co-investments through the creation of a Separately Managed Account (SMA). The manager would assume fiduciary responsibilities and handle all underwriting, reporting, finance, and administration of the SMA. Staff and Cliffwater could source deals from SCERS' existing private equity GPs and portfolio and pass them on to the manager for evaluation and underwriting. The manager could also bring SCERS co-investment opportunities through their deal flow. This would allow SCERS to develop a portfolio while minimizing the demands placed on internal resources. Currently, SCERS has a SMA with Pantheon focused on infrastructure and natural resource secondary investments and co-investments. Pantheon underwrites their owned sourced transactions, and brings them to Staff and Verus for consideration. Staff is considering a similar relationship in the private equity portfolio, in addition to underwriting SCERS' GP deal flow.

Once a structure is in place, Staff and Cliffwater would let the GPs know that SCERS has a co-investment process that can meet GP timelines. Often in SCERS' side letters with GPs, SCERS has expressed interest in co-investment opportunities, but SCERS has not proactively approached GPs to capitalize on opportunities. It would take time to build co-investment deal flow and make investments to build a portfolio; however, after buildout, a co-investment portfolio should be mostly self-funding with distributions exceeding contributions, similar to a portfolio of primary fund investments.

The risks with a co-investment portfolio largely stem from the more concentrated exposure to a single asset. Over time the portfolio would become more diverse by geography, sector, GP, and stage. However, until that diversification comes, a co-investment portfolio would be subjected to greater volatility in quarterly valuations.

NEXT STEPS

Staff and Cliffwater expect to come back to the Board over the next few quarters with more detailed approaches toward implementation within secondaries and co-investments, including any recommendations.

ATTACHMENTS

- Private Equity Implementation Considerations Presentation

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Private Equity Implementation Considerations

April 17, 2019

Introduction

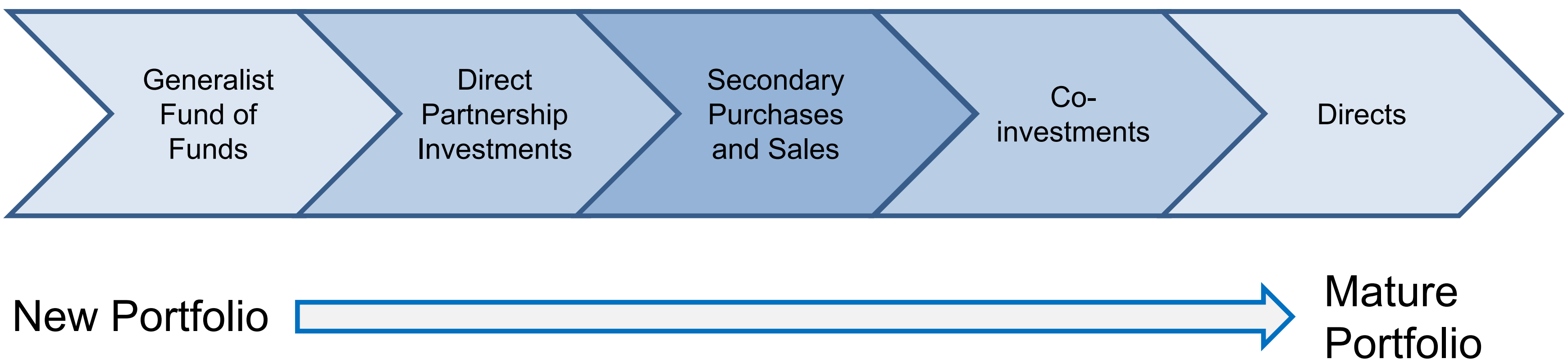
- Review a typical private equity portfolio evolution for institutional investors
- Provide education on secondary investments
- Provide education on co-investments and direct company investments
- Discuss how these transactions can impact a private equity portfolio
- Review potential next steps for SCERS

Typical Private Equity Portfolio Evolution

Private equity investors often follow a typical evolution in their approach to the asset class

- This evolution reflects investors' experience, allocation, and portfolio maturation
- The investment approach will impact
  - Types of investments and vehicles
  - Program objectives
  - Portfolio management tools

Types of Private Equity Investments



An investment approach need not be sequential or fully inclusive of each type shown

Private Equity Investment Types and Vehicles

Fund of Funds (FoFs)

– Commitments made to a FoF vehicle which, in turn, commits to primary private equity funds

Direct Partnership Investments

– Commitments made directly to primary (new) private equity partnerships/funds

Secondary Purchases and Sales

– Privately negotiated purchases or sales of existing private equity funds between LPs

Co-investments

– Direct investments in underlying portfolio companies owned by private equity funds

- Private investments made “side by side” with a private equity general partner

Directs

– Direct private company investments sourced and executed independently by the LP

SCERS Portfolio Evolution

SCERS first began investing in private equity through broadly diversified Fund of Funds

- Sizable commitments to diversified funds to gain broad exposure to private equity
  - Commitments made in 2006 and 2008

SCERS subsequently decided to take a more active role by making direct fund investments

- Began making commitments to a variety of specialized strategies across vintage years
  - First direct partnership commitments made in 2011
- Reflected in-house staff capabilities and the decision to hire an alternatives specialist advisor

Primary focus of the private equity investment program

- Build a well-diversified portfolio by investing with high quality private equity general partners
- Increase the private equity exposure to meet the plan’s strategic asset allocation target
- Gain primary experience and comfort investing in the asset class
- Meet the portfolio’s overall goals and objectives

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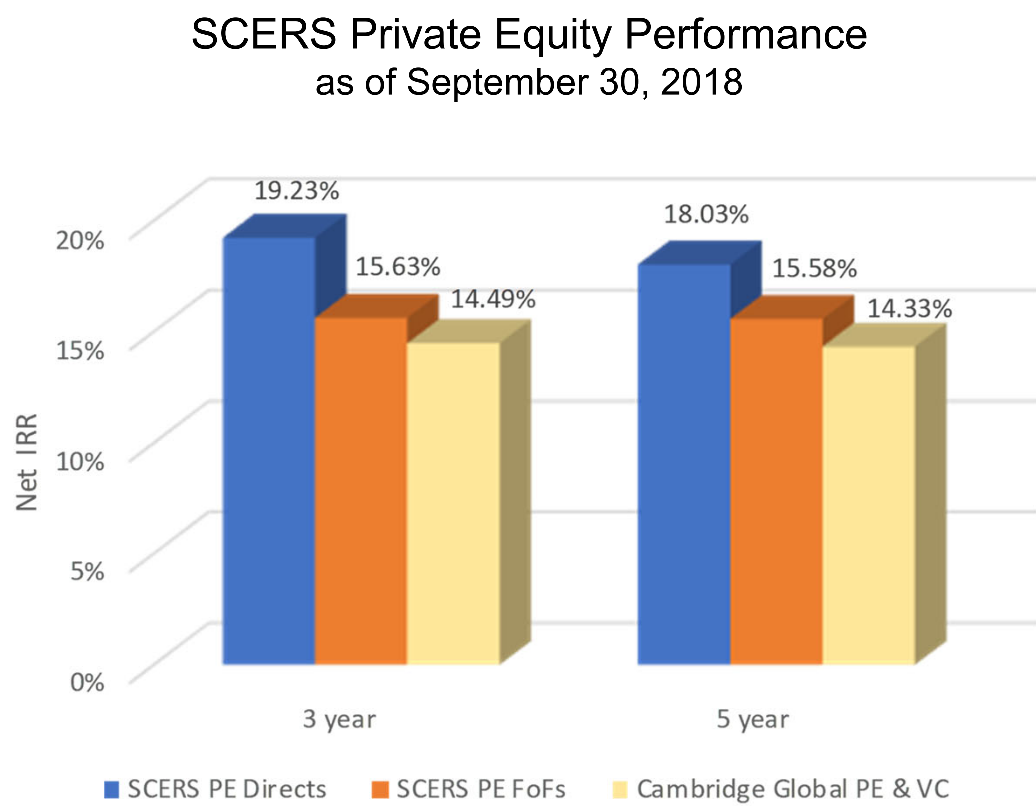
Impact of Going Direct



SCERS' decision to move into direct partnership investments has improved performance

Role of Secondary Transactions

Secondary transactions include the purchase/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
- Investors can also access secondary purchases through actively managed funds
  - SCERS has some exposure to secondary purchases through a few of its fund of funds

Primary objectives for secondary purchases

- Access top-tier general partners that were unavailable through primary investments
- Increase exposure by purchasing invested portfolios that backfill/balance prior vintages
- Generate attractive returns and help to lessen portfolio J-curve impacts

Primary objectives for secondary sales

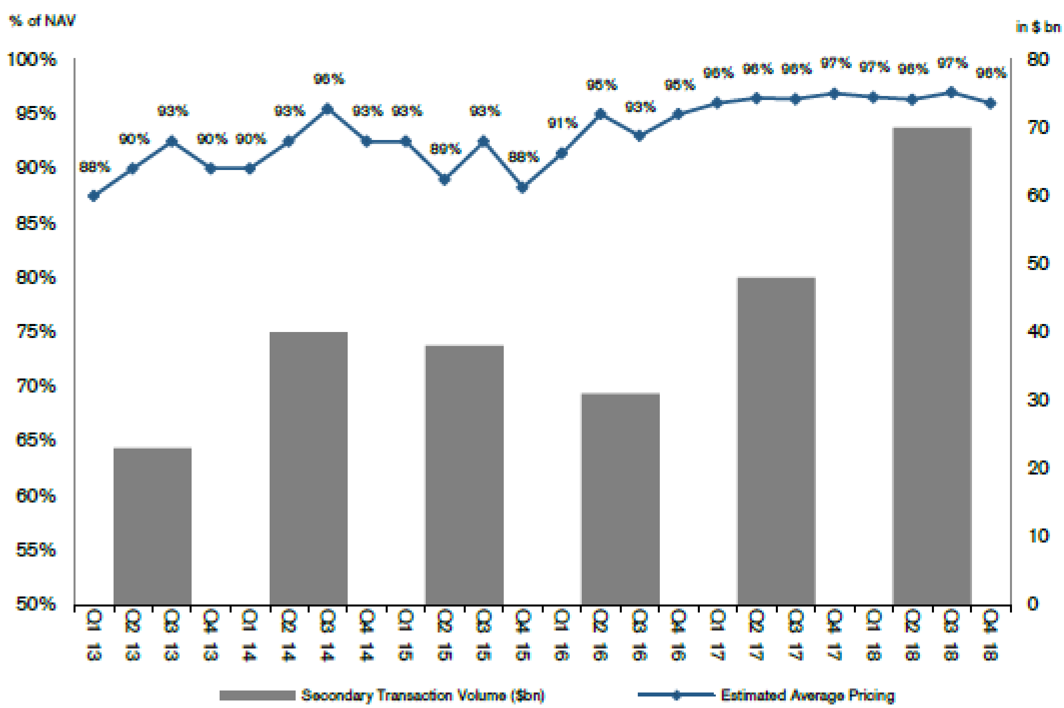
- Consolidate general partner relationships (i.e. limit general partner/fund proliferation)
  - Sell existing funds where the LP does not plan to continue investing in subsequent funds
- Manage overall exposure and/or reduce existing unfunded commitments
- Minimize impact of an underperforming fund while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

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

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

Secondary Market Conditions

Secondary Market Volume and Pricing*



- The market for secondary transactions has grown and matured, with increasing volumes
  - Approximately $70 billion of transactions closed in 2018
- Conditions have favored sellers over buyers
  - Average pricing across private equity funds was approximately 96% of NAV in 2018
    - However, wide variation by quality, with the highest quality buyout funds trading meaningfully above par; lower quality funds often required significant discounts

Source: *Credit Suisse Private Fund Group*

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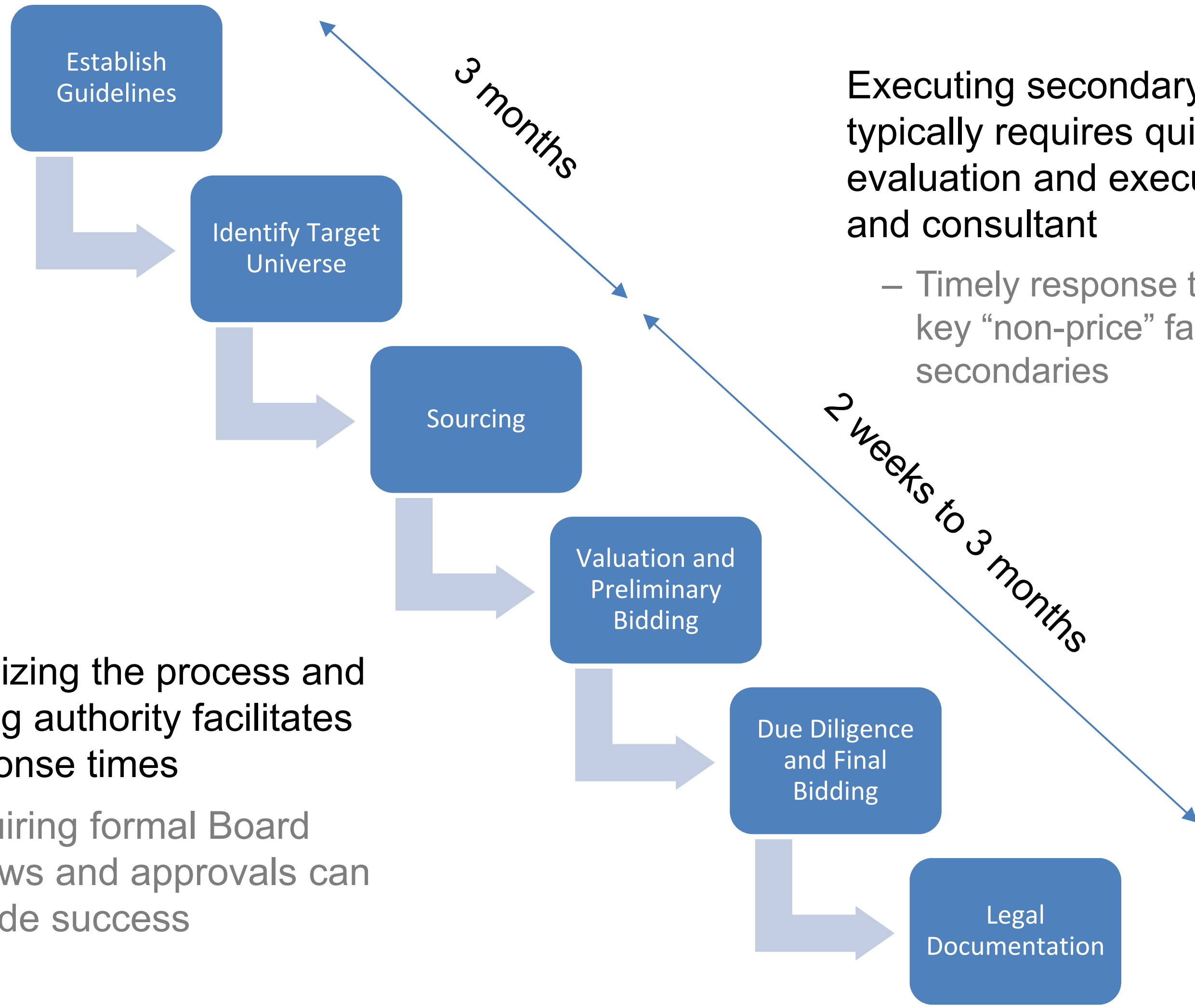
Investment Process for Secondary Purchases



Executing secondary purchases typically requires quick evaluation and execution by staff and consultant

- Timely response time is the key “non-price” factor in buying secondaries

Standardizing the process and delegating authority facilitates fast response times

- Requiring formal Board reviews and approvals can impede success

Evaluation Process for Potential Secondary Sales

Biennial Portfolio Review

Fund Performance v. Expectations

Fund Peer Rankings

Prospective Performance Analysis

Evaluation of GP Roster and Volume

Gauge Market Pricing

An evaluation process could be utilized in conjunction with the existing active monitoring process conducted by the SCERS investment staff and Cliffwater

– Purpose of the process would be to formally identify funds, if any, to potentially consider selling in the secondary market

Attractiveness of potential sales would be determined by the expected pricing in the market

– Pricing for a portfolio sale could be better than single fund sales

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Private Equity 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

Primary objectives for co-investments

– Earn higher returns due to lower fees/carry

  • Lowering overall portfolio fees should not be the primary motivation for co-investment

– Deploy more capital in private investments

  • Should not assume that co-investment results in better selection

Additional risks associated with co-investments

– Potential for adverse selection

– Concentration risk

– Headline risk

– Can require a disproportionate amount of Board/staff/consultant resources, time, and focus

Co-investment opportunities typically arise when an investment cannot be fully funded by the fund

– Usually driven by a fund's concentration limits or diversification requirements

– Could have opportunities for an investment that does not fit the fund's strategy

  • More of a "strategic opportunity" than a typical co-invest

Co-Investment Approaches

Approach	Description	Cost (Fees/Carry)	Selection Breadth	Required Resources
Direct Co-investment	Directly seeking co-investments from existing GPs	Low (0%/0%)	Moderate	High
Co-investment Manager	Hire third party to seek, select and manage co-investments	Moderate to High (1%/10%)	High	Low
Hybrid Direct/Manager	Customized approach with dedicated manager	Moderate (TBD, likely below 1%/10%)	Moderate to High	Low to Moderate
Overflow Fund	Side-car vehicle used by GP for investments too large for main fund	Low (0%/0%)	Low	Low

Other considerations including the investor's disclosure requirements and desired level of diversification among co-investments will impact an investor's preferred approach

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Direct Private Investments

- Direct private company investments sourced and executed independently by the LP
  - Different than co-invest as not investing alongside a private equity general partner
- There are significant challenges associated with direct private investments
  - Requires significant resources and in-house expertise to source, execute, and manage
    - Also often requires higher compensation than is typical for generalist investment staff
  - High degree of risk, including potential headline risk
  - Can require an inordinate amount of staff and board attention
  - Improper governance can lead to sub-optimal selection and outcomes
    - Impact of politically influenced decisions or investments made to promote differing agendas
  - May create conflicts with other portfolio investments
- Championed by some Canadian plans and talks at a few large California plans
  - However, co-investment programs could offer a better alternative to direct investments for most plan sponsors

Private Equity Portfolio Considerations Going Forward

- Balance allocations to top-tier general partners with a reasonable number of relationships
- Maintain the allocation within its strategic allocation range
- Evaluate the potential impact of co-investments and secondary transactions
- Continue to generate strong performance and meet portfolio objectives

Next Steps

- Portfolio evaluations
- Provide further Board education
- Potential recommendations on co-investments and/or secondary transactions

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