



## Investment Committee Agenda Item 8a

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**March 18, 2019**

**Item Name:** Private Equity Business Model

**Program:** Total Fund

**Item Type:** Action

### **Recommendation**

Approve the concept of including Pillars III (Late Stage Venture/Growth) and IV (Long Hold) as parts of the Private Equity Strategic Business Model.

### **Executive Summary**

Over the past 18 months Staff has had ongoing dialogue with the Investment Committee about the private equity market and its inclusion within the CalPERS asset allocation. The organization's exposure to this asset class has been slowly declining as the pace of capital commitments and calls have not kept up with the level of capital distributions back to CalPERS. Staff believe that maintaining or increasing exposure to this asset class is required to support the assumed rate of return targeted for the public Employees' Retirement Fund (PERF).

The market examination has led to the conceptual framework of four pillars. Pillar I (Emerging Managers) and Pillar II (Traditional Partnerships) represent the avenues by which CalPERS has participated in the market to date. Pillars III and IV have been delineated to increase the market access paths for CalPERS, while seeking to also improve the alignment between the general partners and CalPERS.

Staff is requesting Investment Committee support for the concept of including Pillars III and IV as parts of the Private Equity Strategic Business Model.

### **Strategic Plan**

This item supports California Public Employees' Retirement System (CalPERS) Strategic Plan goal of improving long-term pension and health benefit sustainability. The inclusion of Pillars III and IV, to operate alongside Pillars I and II (existing emerging manager and traditional partnership models) is intended to assist in maintaining and increasing investment exposure to the private equity asset class over time. Additional objectives of this effort are improving transparency, control, and focus, while decreasing costs and asset turnover.

## Investment Beliefs

This item supports the following CalPERS' Investment Beliefs:

- Investment Belief 1: Liabilities must influence asset structure
- Investment Belief 2: A long time investment horizon is a responsibility and an advantage
- Investment Belief 4: Long-term value creation requires effective management of the three forms of capital: financial, physical and human
- Investment Belief 6: Strategic asset allocation is the dominant determinant of portfolio risk and return

## Background

Staff has provided the Investment Committee with information on Pillars III and IV at multiple meetings for the past year. As covered during the February 2019 Board Investment Committee presentation, CalPERS would eventually invest in separate vehicles aligned to Pillars III and IV.

If approved by the Investment Committee, staff shall continue to the next phase of implementation, the identification and negotiation with potential partners. Investment Committee approval of the concept's inclusion within the Private Equity Strategic Plan, is believed important as a signal to the market that CalPERS is serious about implementing Pillars III and IV. Such a demonstration of intent should aid in the identification of a pipeline of potential partners.

## Analysis

Attachment 1 consolidates some of the information presented to the Investment Committee at various time points in the assessment of the private equity business model. Key observations are:

- Private equity has provided significantly higher returns than other asset classes, especially since the financial crisis.
- The number of publicly traded companies has been declining.
- CalPERS current pace of capital commitments and calls is insufficient to have the prospect of increasing the level of exposure to the asset class.
- Simply increasing capital commitments via the existing private equity activities, risks an over diversification of managers (simply adding more of them) which could lead to creating an "index" of private equity with likely lower return prospects.

The observations above underlie the motivation to seek alternatives to CalPERS existing private equity activities. The focus of Pillar III will be late stage investments in technology, life sciences and healthcare. Pillar IV would be targeted at long-term investments in established companies. In addition to Pillars III and IV, staff intend to expand some of the activity in Pillars I and II such as co-investments.

The timeline required for full implementation of Pillars III and IV is unknown and dependent on the identification and successful negotiation with capable partners. Staff shall report the ongoing status of the effort to the Investment Committee, as well as bringing any needed policy changes to the Committee for approval. Prior to any funding of a Pillar III or IV vehicle, a Prudent Person Opinion (PPO) shall be available to the Investment Committee.

## **Budget and Fiscal Impacts**

Staff time and travel expense to assess the business model, identify potential partners, conduct due diligence and negotiate contracts. Implementation of Pillars III and IV will require funding an operating budget for the vehicles in lieu of typical partnership management fees.

## **Benefits and Risks**

The primary benefits assumed from Pillars III and IV are increasing the scale of the Private Equity asset class and fostering an improved alignment of interest with the partners. Risks relate to the ability to identify partners that will ultimately be successful executing the strategies, the ability of partners to build adequate teams, reaching adequate scale to reduce the operating budgets below the typical management fee costs associated with typical partnerships and the potential capital concentration in the eventual investments.

## **Attachments**

Attachment 1 – Private Equity Business Model Presentation

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John Cole  
Investment Director

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Ben Meng  
Chief Investment Officer

# Private Equity Business Model

March 18, 2019

# Private Equity Business Model Review

1. Why Private Equity
2. Challenges
3. Pillars I and II: Opportunities
4. Pillars III and IV: Opportunities
5. Pillars III and IV: Risks and Mitigation
6. Pillars III and IV: Transparency
7. Next Steps

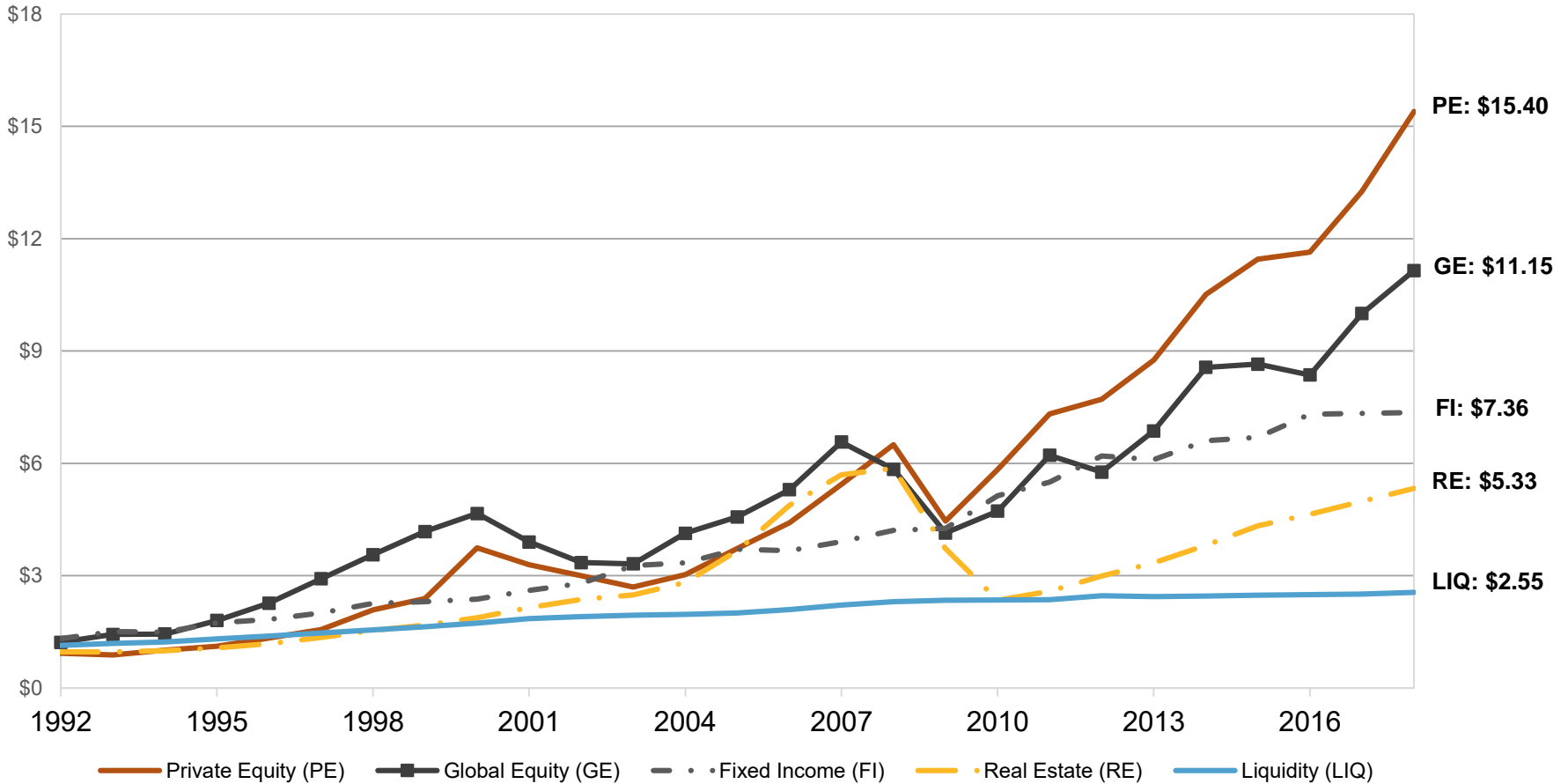
## Why Private Equity

- Private equity is an increasingly important part of global capital markets
- Private Equity is the only asset class that is expected to exceed the actuarial rate of 7% (2017 Asset Liability Management – Capital Markets Assumptions)
- Realized drawdown and volatility lower than assumptions
- Historical performance

# Private Equity Business Model

## Value Added From Private Equity

**Cumulative Net-of-Fee Returns based on \$1 Invested (a)**



(a) Source: StateStreet – Based on annual data for 28 fiscal years ending June 30, 2018; Inflation-sensitive, Infrastructure and Forestland asset classes were excluded due to data limitations

## Challenges

- CalPERS would like to prudently increase the allocation to Private Equity over time
- Avoiding “index like” returns, CalPERS requires a portfolio concentrated on aligned, capable and reasonably high performing partners

## Existing Pillar I: Emerging Managers

- Goal to identify and cultivate the next generation of investment managers
- Implemented in a Fund of Funds model with Grosvenor is the manager

From	To
\$100 million mandate	\$500 million mandate
1 <sup>st</sup> and 2 <sup>nd</sup> time funds	1 <sup>st</sup> , 2 <sup>nd</sup> and 3 <sup>rd</sup> time funds
No co-investments allowed	Co-investments allowed

## Existing Pillar II: Traditional Partnerships

Developing more collaborative strategic relationships to extend CalPERS' reach would;

- Create a global presence
- Augment middle market and international general partners
- Enhance skills for co-investments, co-sponsorships and secondary market capabilities
- Improve access to data and technology to advance investment decision-making process

## Pillars III and IV: Opportunities

- Scale Private Equity exposure
- Migrate to a more cost efficient model
- Improve alignment of interest
- Pillar III
  - Take advantage of companies staying private for longer
  - Technology, Life Sciences & Healthcare = faster growth
- Pillar IV
  - Long term hold of core economy companies with positive cash flows
  - Reduce asset turnover expense

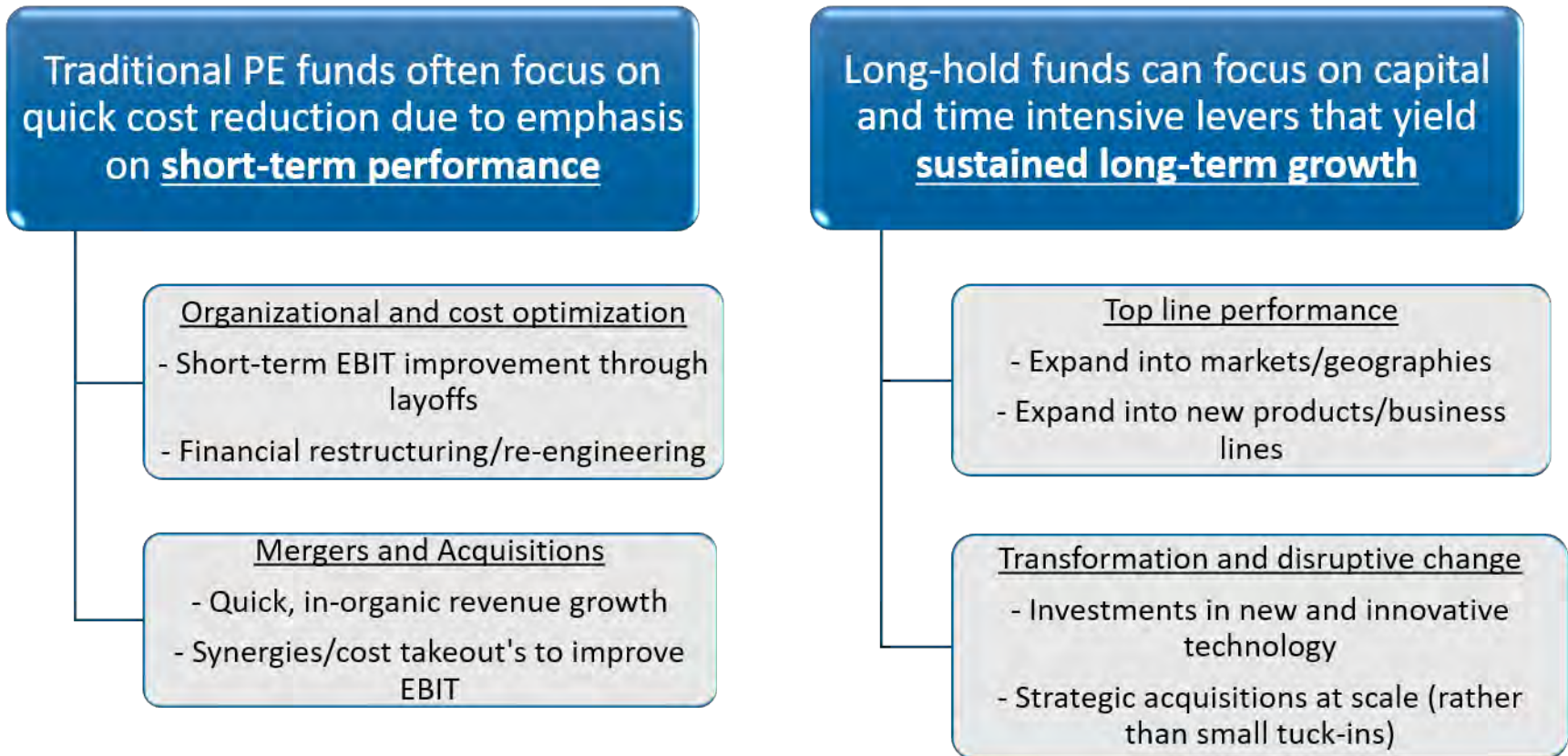
## Private Equity Business Model

# Pillars III and IV: Key Risks and Mitigation

	Potential risks to CalPERS	Mitigation Strategies
Concentration Risk	<ul style="list-style-type: none"> <li>Concentrated with a handful of partners, much greater capital than in any other single fund</li> <li>In Pillar 4, few large investments means higher impact if one goes poorly, though large companies are typically more stable</li> <li>In Pillar 3, investment in late-stage Venture Capital is inherently more volatile than buyout</li> </ul>	<ul style="list-style-type: none"> <li>Important to acknowledge higher and more concentrated risk but within the context of CalPERS Total Fund</li> <li>Industry and geographic concentration should be considered in the context of the total equity (global equity and private equity) portfolio</li> </ul>
Reliance on key partners	<ul style="list-style-type: none"> <li>Success of Pillars 3 and 4 is dependent on top-tier Partners who can further define and execute strategies</li> <li>Partners must have a successful track record and be able to build out new teams from ground up</li> </ul>	<ul style="list-style-type: none"> <li>Careful selection and diligence of Partners is essential</li> <li>The ability to act quickly will mitigate risk of losing Partners who may have other opportunities</li> </ul>
Investment timelines vs. Partner commitments	<ul style="list-style-type: none"> <li>Initial commitment to Pillars 3 and 4 will have a fixed term that is likely shorter than the time to realize returns on their investments</li> </ul>	<ul style="list-style-type: none"> <li>Create a structural commitment to the strategy</li> <li>Align incentives with Partners to focus on long term performance and holds</li> </ul>
Return dilution	<ul style="list-style-type: none"> <li>Longer hold periods may dilute the high annual returns seen in short-hold private equity, especially in the early years</li> </ul>	<ul style="list-style-type: none"> <li>Consider potential dilution in benchmark setting</li> <li>Utilize longer-term metrics to supplement performance metrics</li> </ul>

## Pillars III and IV: Key Risks and Mitigation

In long-hold private equity strategy, funds can utilize longer term value creation levers



## Pillars III and IV: Transparency

- Operational transparency to staff greater than currently received from comingled funds
- Public transparency identical to existing Private Equity funds

Strategy	Transparency to CalPERS	Transparency to the Public
Comingled Funds	<ul style="list-style-type: none"> <li>• Financial Statements</li> <li>• Quarterly Templates</li> <li>• Annual Meeting Materials</li> <li>• Capital Calls and Distribution Notices</li> <li>• Limited Portfolio Company Information</li> <li>• Limited visibility on costs</li> </ul>	<ul style="list-style-type: none"> <li>• Commitment and Performance Information</li> <li>• Annual Management Fees and Expenses</li> <li>• Carried Interest Distributed</li> <li>• Pro rata share of fees and expenses paid by portfolio companies</li> </ul>
Pillars III & IV	<p>All of the above plus</p> <ul style="list-style-type: none"> <li>• Detailed Portfolio Company Information</li> <li>• Budget – full details on costs</li> <li>• Periodic Meetings between Senior INVO Staff and the Investment Manager</li> <li>• Detailed Investment Pipeline Information</li> </ul>	<ul style="list-style-type: none"> <li>• Commitment and Performance Information</li> <li>• Annual Management Fees and Expenses</li> <li>• Carried Interest Distributed</li> <li>• Pro rata share of fees and expenses paid by portfolio companies</li> </ul>

## Next Steps

- Investment Committee approval to include Pillars III and IV Concept in Private Equity Strategic Business Model
- Identification of and successful negotiation with capable partners
- Continued reporting to Investment Committee on status
- Investment Committee approval of any needed policy changes
- Prudent Person Opinion available to Investment Committee prior to any funding of Pillar III or IV vehicle