Private Equity Business Model

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CalPERS

Private Equity Business Model Review

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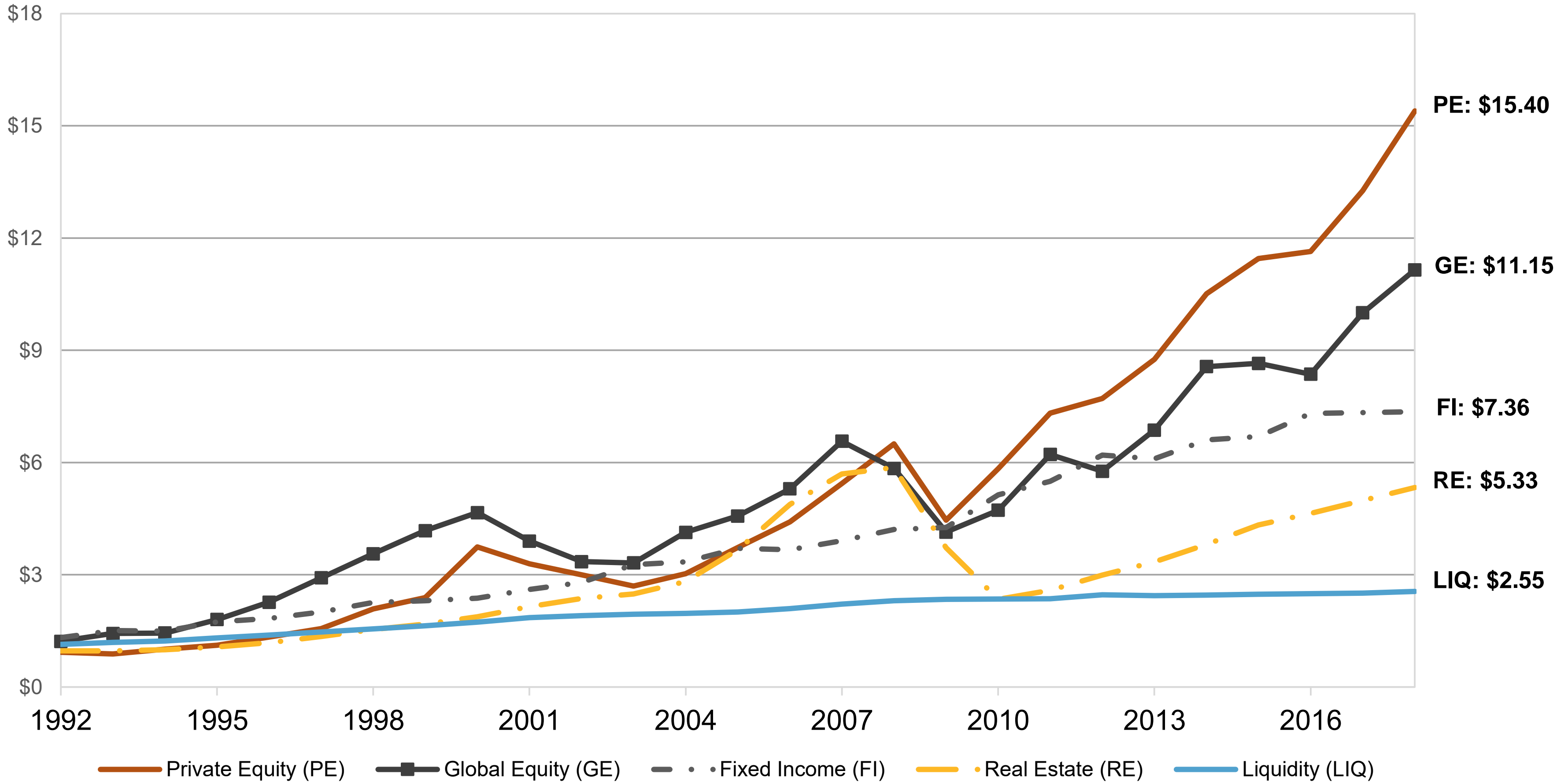
Why Private Equity

- 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

Value Added From Private Equity



(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

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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
1st and 2nd time funds	1st, 2nd and 3rd 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

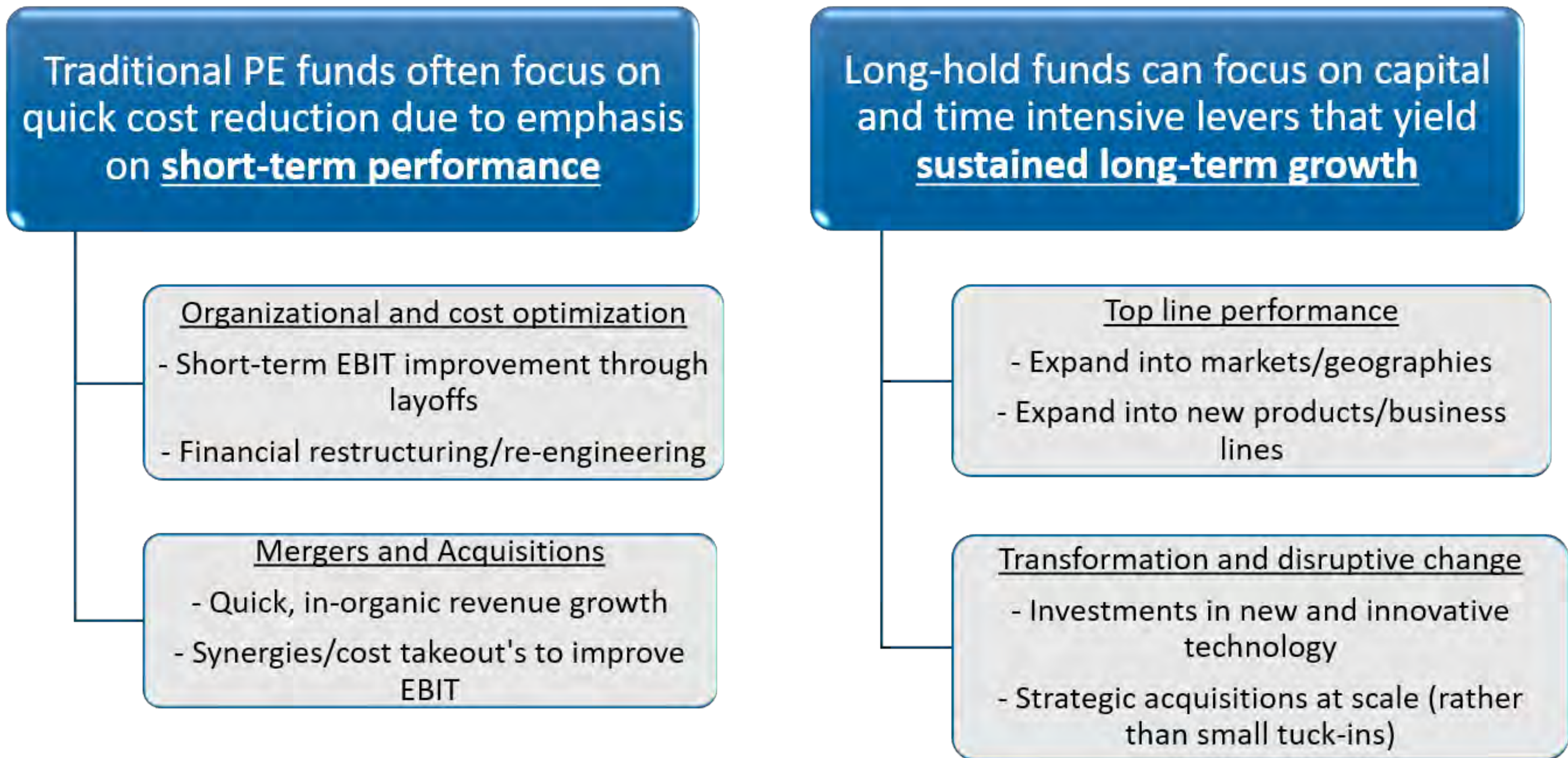
- Scale Private Equity exposure
- Migrate to a more cost efficient model
- Improve alignment of interest
- Pillar III
  - Take advantage of companies staying private for longer
  - Technology, Life Sciences & Healthcare = faster growth
- Pillar IV
  - Long term hold of core economy companies with positive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

Pillars III and IV: Key Risks and Mitigation

Potential risks to CalPERS		Mitigation Strategies
Concentration Risk	• Concentrated with a handful of partners, much greater capital than in any other single fund • In Pillar 4, few large investments means higher impact if one goes poorly, though large companies are typically more stable • In Pillar 3, investment in late-stage Venture Capital is inherently more volatile than buyout	• Important to acknowledge higher and more concentrated risk but within the context of CalPERS Total Fund • Industry and geographic concentration should be considered in the context of the total equity (global equity and private equity) portfolio
Reliance on key partners	• Success of Pillars 3 and 4 is dependent on top-tier Partners who can further define and execute strategies • Partners must have a successful track record and be able to build out new teams from ground up	• Careful selection and diligence of Partners is essential • The ability to act quickly will mitigate risk of losing Partners who may have other opportunities
Investment timelines vs. Partner commitments	• 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	• Create a structural commitment to the strategy • Align incentives with Partners to focus on long term performance and holds
Return dilution	• Longer hold periods may dilute the high annual returns seen in short-hold private equity, especially in the early years	• Consider potential dilution in benchmark setting • Utilize longer-term metrics to supplement performance metrics

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	• Financial Statements • Quarterly Templates • Annual Meeting Materials • Capital Calls and Distribution Notices • Limited Portfolio Company Information • Limited visibility on costs	• Commitment and Performance Information • Annual Management Fees and Expenses • Carried Interest Distributed • Pro rata share of fees and expenses paid by portfolio companies
Pillars III & IV	All of the above plus • Detailed Portfolio Company Information • Budget – full details on costs • Periodic Meetings between Senior INVO Staff and the Investment Manager • Detailed Investment Pipeline Information	• Commitment and Performance Information • Annual Management Fees and Expenses • Carried Interest Distributed • Pro rata share of fees and expenses paid by portfolio companies

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