Private Equity Business Model

March 18, 2019
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

Cumulative Net-of-Fee Returns based on $1 Invested

<table>
<thead>
<tr>
<th>Year</th>
<th>Private Equity (PE)</th>
<th>Global Equity (GE)</th>
<th>Fixed Income (FI)</th>
<th>Real Estate (RE)</th>
<th>Liquidity (LIQ)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>$0</td>
<td>$2.55</td>
<td>$3.25</td>
<td>$3.36</td>
<td>$2.55</td>
</tr>
<tr>
<td>1995</td>
<td>$3</td>
<td>$6.40</td>
<td>$6.25</td>
<td>$5.66</td>
<td>$2.55</td>
</tr>
<tr>
<td>1998</td>
<td>$6</td>
<td>$11.40</td>
<td>$10.00</td>
<td>$8.33</td>
<td>$2.55</td>
</tr>
<tr>
<td>2001</td>
<td>$9</td>
<td>$15.30</td>
<td>$14.25</td>
<td>$13.66</td>
<td>$2.55</td>
</tr>
<tr>
<td>2004</td>
<td>$12</td>
<td>$18.30</td>
<td>$17.25</td>
<td>$16.66</td>
<td>$2.55</td>
</tr>
<tr>
<td>2007</td>
<td>$15</td>
<td>$21.00</td>
<td>$20.00</td>
<td>$19.66</td>
<td>$2.55</td>
</tr>
<tr>
<td>2010</td>
<td>$18</td>
<td>$24.00</td>
<td>$23.00</td>
<td>$22.66</td>
<td>$2.55</td>
</tr>
<tr>
<td>2013</td>
<td>$21</td>
<td>$27.00</td>
<td>$26.00</td>
<td>$25.66</td>
<td>$2.55</td>
</tr>
<tr>
<td>2016</td>
<td>$24</td>
<td>$30.00</td>
<td>$29.00</td>
<td>$28.66</td>
<td>$2.55</td>
</tr>
</tbody>
</table>

(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

<table>
<thead>
<tr>
<th>From</th>
<th>To</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100 million mandate</td>
<td>$500 million mandate</td>
</tr>
<tr>
<td>1\text{st} and 2\text{nd} time funds</td>
<td>1\text{st}, 2\text{nd} and 3\text{rd} time funds</td>
</tr>
<tr>
<td>No co-investments allowed</td>
<td>Co-investments allowed</td>
</tr>
</tbody>
</table>
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

<table>
<thead>
<tr>
<th>Potential risks to CalPERS</th>
<th>Mitigation Strategies</th>
</tr>
</thead>
</table>
| **Concentration Risk**    | • 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 |
| **Success of Pillars 3 and 4 is dependent on top-tier Partners who can further define and execute strategies** | • Careful selection and diligence of Partners is essential  
                            • The ability to act quickly will mitigate risk of losing Partners who may have other opportunities |
| **Partners must have a successful track record and be able to build out new teams from ground up** | • Create a structural commitment to the strategy  
                            • Align incentives with Partners to focus on long term performance and holds |
| **Investment timelines vs. Partner commitments** | • 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.

**Traditional PE funds often focus on quick cost reduction due to emphasis on short-term performance**

- Organizational and cost optimization
  - Short-term EBIT improvement through layoffs
  - Financial restructuring/re-engineering

- Mergers and Acquisitions
  - Quick, in-organic revenue growth
  - Synergies/cost takeout’s to improve EBIT

**Long-hold funds can focus on capital and time intensive levers that yield sustained long-term growth**

- Top line performance
  - Expand into markets/geographies
  - Expand into new products/business lines

- Transformation and disruptive change
  - Investments in new and innovative technology
  - Strategic acquisitions at scale (rather than small tuck-ins)
### Pillars III and IV: Transparency

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

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Transparency to CalPERS</th>
<th>Transparency to the Public</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Commingled Funds</strong></td>
<td>• Financial Statements&lt;br&gt;• Quarterly Templates&lt;br&gt;• Annual Meeting Materials&lt;br&gt;• Capital Calls and Distribution Notices&lt;br&gt;• Limited Portfolio Company Information&lt;br&gt;• Limited visibility on costs</td>
<td>• Commitment and Performance Information&lt;br&gt;• Annual Management Fees and Expenses&lt;br&gt;• Carried Interest Distributed&lt;br&gt;• Pro rata share of fees and expenses paid by portfolio companies</td>
</tr>
<tr>
<td><strong>Pillars III &amp; IV</strong></td>
<td>All of the above plus&lt;br&gt;• Detailed Portfolio Company Information&lt;br&gt;• Budget – full details on costs&lt;br&gt;• Periodic Meetings between Senior INVO Staff and the Investment Manager&lt;br&gt;• Detailed Investment Pipeline Information</td>
<td>• Commitment and Performance Information&lt;br&gt;• Annual Management Fees and Expenses&lt;br&gt;• Carried Interest Distributed&lt;br&gt;• Pro rata share of fees and expenses paid by portfolio companies</td>
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</table>
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