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CalPERS Private Equity Emerging Manager Program Review

Anita Ng
Managing Director, Cambridge Associates

Project Scope and Process

Objective

- Identify lessons learned and adopt any additional best practices for investing in emerging private equity managers

Methodology

- Detailed review of 10 direct emerging managers and 3 funds of funds

Panel discussions

- Panel of CalPERS' senior staff, consultants and 9 external industry experts
- 3 day-long workshop sessions

- Investing in private equity in general is challenging for even the most sophisticated LPs
- The private equity industry is mature and increasingly competitive
- Less information available to prospective LPs
- Greater inherent uncertainty as newer teams learn how to work together and execute their strategy, manage a portfolio, face unexpected developments, and build their organization
- Less proven strategies
- Potential distractions arising from fundraising difficulty

- Given their unique challenges, why does CalPERS invest in emerging managers?

  - **Access the comprehensive landscape of investment opportunities**

  - **Develop relationships with the next generation of core investment managers**

  - **Generate appropriate risk-adjusted returns**

- Emerging managers should be held to the same standards as established managers
- CalPERS generally should not invest in emerging venture capital managers
- Selectively invest directly when appropriate, but continue to use funds of funds to gain emerging manager exposure
- No “secret sauce” alone can explain the success or failure of emerging managers

Continued

- The study suggested a number of factors that are particularly important, keeping in mind:
  - Sample size not statistically significant and selection relied upon some degree of subjectivity
  - Some factors are more important than others, and factors that matter most will vary by situation
  - Some factors are correlated and there is interplay between the factors

Most Important Factors

	• Strategies of scale, and repeatable
Attractive investment thesis	• Sustainable and growing addressable market opportunities • Strategy differentiation <u>or</u> deep sector expertise
Prior relevant investing experience	• Edge in sourcing and relevant industry networks • Relevant investing experience as principal investors • Prior fund management experience • Previous experience working together
Team dynamics	• Avoid groups with unchallenged single dominant partners able to make unilateral investment decisions • Intense cultural focus on introspection and striving for continual improvement

Most Important Factors, Continued

Clearly articulated strategy	• A clear identity recognized and understood by all team members • Explicit and consistent decision-making structures and processes in place
Strategy adherence	• Adherence to strategy that was defined at the onset of each fund
GP/LP Alignment	• Meaningful "skin in the game" • Fair economics sharing to properly motivate team • Transparency and integrity

Other Factors To Consider

- Ensure “critical mass”
- Ability to attract and retain additional talent around key founders
- Early professional turnover can signify deeper problems
- Sponsorship/endorsement/commitment from previous employer(s) or knowledgeable LPs can offer some level of validation

Other Factors To Consider, Continued

- Historical performance evaluation
- “Hungry” team. Understand the rationale for the founders wanting to start a new firm
- Funds sponsored by larger, more established organizations may result in reduced alignment of interests of an investment team with LPs
- Though not observed in our sample, the panel believes that unconstrained fund size growth is a negative