Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 17

MEETING DATE: **September 19, 2018**

SUBJECT: **Private Equity Small/Lower-Middle Market Buyout Investing**

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

RECOMMENDATION

Staff recommends the Board receive and file the presentation on private equity small/lower-middle market buyout investing.

PURPOSE

This agenda item supports the 2018-19 Strategic Management Plan by identifying an approach to implementing the annual investment plan for the Private Equity asset class. The agenda item outlines adding dedicated small/lower-middle market buyout fund of funds (FoF) exposure within the Private Equity asset class, to complement SCERS' existing Private Equity portfolio.

SUMMARY

Staff and Cliffwater believe that investing in a small/lower-middle market buyout FoF will complement SCERS' Private Equity portfolio. Small/lower-middle market buyout, which is defined as funds that typically raise between $250 million and $1 billion in capital, is an attractive segment of private equity. The small/lower-middle market buyout segment is a less efficient market than the larger buyout segments, has a large universe of companies to source from, and historically has had lower entry multiples. While the upper quartile range of the segment has been the best performing segment of the broader private equity market, small/lower-middle market buyout returns have meaningful variability associated with them.

To avoid concentrated allocations within the SCERS direct private equity portfolio, this variability emphasizes using a specialist small/lower-middle market FoF manager for implementation, who has expertise in, and a track record of allocating to top performing funds. Using a FoF includes an extra layer of fees and carried interest, in addition to fees and carried interest charged by the underlying GPs in the FoF portfolio, so this investment approach would need to be offset by the differentiation of the FoF and its ability to generate outsized returns.

A dedicated allocation to small/lower-middle market buyout fits within SCERS Private Equity portfolio construction, as approximately two-thirds of SCERS' current portfolio is allocated to funds that raised over $1 billion in capital, with an average size of $2 billion.

Staff and Cliffwater are contemplating an overall commitment to a small/lower-middle market buyout FoF manager of up to $100 million that would invest across primary fund investments, secondary fund investments, and co-investments. The recommendation of a small/lower-middle market buyout FoF mandate, would take place according to the implementation protocol identified within the investment policy statement for the Private Equity asset class

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 June 30, 2018) is 8.2%. 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, through 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 a number of strategies and private equity funds, and is often used by smaller investors who seek to avoid concentrated exposure across funds and managers.

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 partnerships. Since 2011, SCERS has exclusively invested directly into private equity partnerships, and has not made any additional FoF investments. Over this period, SCERS has established relationships with 18 private equity general partners (GPs), and invested across 42 limited partnership funds. While SCERS has not made any recent FoF investments within the Private Equity portfolio, SCERS does have FoF mandates within the Absolute Return asset class (Grosvenor Capital Management), and the Real Assets asset class (Pantheon Ventures).

SCERS' direct approach to private equity has been successful with strong returns on an absolute and relative basis. As of June 30, 2018, SCERS' total since inception Private Equity net internal rate of return (IRR) is 13.2% versus the policy index benchmark (Cambridge Associates Global Private Equity and Venture Capital pooled IRR) return of 12.7%. The net total value to paid in capital (TVPI) is 1.41x. These returns are strong, especially considering that SCERS' private equity portfolio is earlier in its investments cycle (J-Curve impact) and is therefore less seasoned than the benchmark. Over the 3-year and 5-year periods, SCERS' Private Equity portfolio has generated a net IRR of 15.6% and 15.7%, respectively, versus the policy index benchmark net IRR of 12.1% and 13.5%, respectively.

SCERS PRIVATE EQUITY Performance Summary for the periods ending 3/31/18	1-Year	3-Year	5-Year	Since Inception	Since Inception Date
SCERS Private Equity	22.0%	15.6%	15.7%	13.2%	Feb-08
Cambridge Private Equity/Venture Capital	18.0%	12.1%	13.5%	12.7%	

FUND OF FUNDS

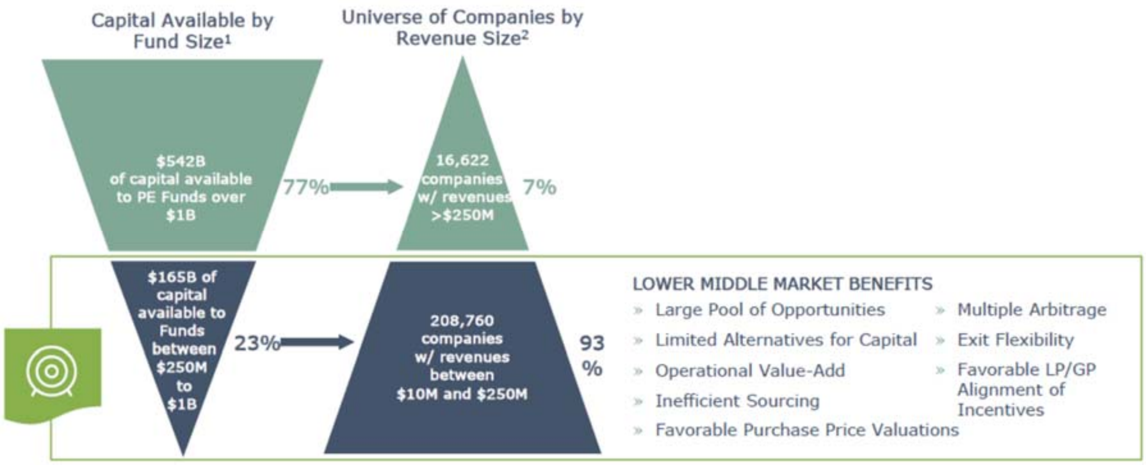
In the past, Staff and Cliffwater have referenced the potential to utilize strategic partnerships and FoFs within private equity as a complement to the direct private equity portfolio, to invest in certain constrained private equity segments that are challenging to directly invest in. Example segments include small-market buyout, venture capital, and emerging markets. Constraints within these segments include limitations on access to underlying GPs, restrictions on accessing funds in scale, and limited SCERS resources. A FoF mandate within these segments would provide added scale and efficiencies for SCERS; however, the benefits would need to outweigh the extra layer of management fees associated with FoFs.

A challenge with a FoF is that limited partners (LPs) in the FoF pay an extra layer of management fees and carried interest to the FoF manager, which are in addition to the fees and carried interest that the FoF (or SCERS) pays to the GPs of the underlying funds within the FoF portfolio. The extra layer of fees can therefore degrade the returns of a FoF. Private equity is an asset class with high fee structures combined with high return expectations, so any increase in the level of fees paid needs to be offset by the differentiation of the FoF and its ability to generate outsized returns. A FoF approach is validated when the FoF manager provides an investor like SCERS with exposure to a segment of private equity that is difficult to access or to build a portfolio of scale, and in which the FoF manager has a demonstrated track record of earning strong returns net of both the underlying GP fees and carried interest, and the FoF fees and carried interest.

SMALL/LOWER-MIDDLE MARKET BUYOUT

A particular private equity segment where a FoF approach makes sense, and where Staff and Cliffwater have been performing due diligence, is the small/lower-middle market buyout segment. Typically, the private equity buyout category is broken out between three segments (though definitions can vary): (1) small market buyout – funds that are less than $500 million; (2) middle market buyout – funds between $500 million and $2 billion; and (3) large market buyout – funds that are greater than $2 billion.

Small and lower-middle market buyout, for purposes of this discussion refers to funds raising less than $1 billion in capital; typically between $250 million and $1 billion and averaging around $500 million. As the diagram below shows, the majority of institutional private equity capital is allocated to funds targeting over $1 billion in capital versus sub-$1 billion funds (77% vs. 23%); however, there is a much larger universe of companies that are targeted by sub-$1 billion funds.

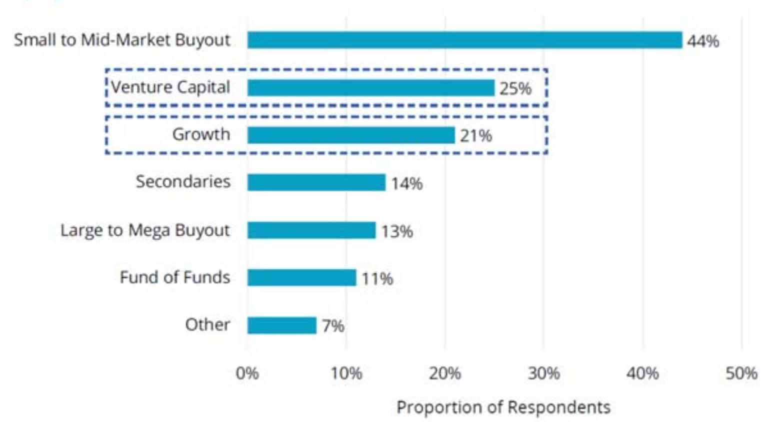


Source: RCP Advisors

There are several advantages to investing in the small/lower-middle market buyout segment. Given the larger pool of opportunities, the small-market and lower-middle market buyout segments are less efficient markets than the larger segments, which translates to greater sourcing opportunities and lower entry multiples. According to Preqin, for private equity deals completed between 2007 and 2016, the average Enterprise Value/EBITDA entry multiple was 4.1x for small-market buyout, compared to 8.2x for middle-market and 10.7x for large market. This is an important statistic, given increasing entry multiples over the past several years within private equity and the broader markets. The use of leverage also tends to be less in small-market and lower middle-market buyout compared to the larger buyout segments. Debt/EBITDA multiples over the aforementioned 2007 to 2016 period were 2.2x for small-market buyout, compared to 3.9x for middle-market and 5.0x for large-market buyout.

Given the number of funds and underlying companies within the small/lower-middle market buyout segment, and the number of investors showing interest in the space (as shown in the chart), investing in the small/lower-middle market buyout segment warrants utilizing a FoF specialist. Investment opportunities within the small/lower-middle market buyout segment are often with GPs that have raised capital for and invested multiple funds; however, they can also include GPs that are

Fig. 5: Fund Types that Investors View as Presenting the Best Opportunities in Private Equity over the Next 12 Months



Source: Preqin Investor Interviews, June 2018 investing first and second time funds. SCERS typically avoids investing with a GP in the direct private equity portfolio until it has demonstrated a successful track record of investing, but in a diversified FoF, first and second time funds are more acceptable. A dedicated small/lower-middle market buyout specialist has the resources to narrow down the universe of funds, develop and maintain GP relationships, and will have a lengthy track record of investing in the space.

The historical returns of the sub-$1 billion buyout segment are attractive. As the chart below shows, while the median returns of the segment have lagged those of the greater than $1 billion segment, the upper quartile range of the segment has historically been the best performing segment within the broader private equity market. This makes sense, since small/lower-middle market buyout is a less efficient segment than larger market buyout. This inefficiency creates the opportunity for outsized returns, but also translates to greater variability of returns and a wider range of outcomes (both to the upside and downside). The greater variability is a reason not to make an abundance of concentrated allocations to unfamiliar underlying GPs and funds through SCERS' direct private equity portfolio, but to take a more diversified approach with a specialist FoF manager, who should have access to, and expertise in, allocating to top performing managers.

Source: RCP Advisors

SCERS PORTFOLIO FIT

Within SCERS' direct private equity portfolio, and specifically within the buyout segment, SCERS has historically avoided the largest funds within the buyout segment. SCERS has made a total of 21 buyout investments within the direct private equity portfolio since 2011. Out of these 21 investments, the average fund size has been ~$2 billion, with a median fund size of ~$1.3 billion. SCERS' Private Equity portfolio also consists of 12 venture capital fund investments, 7 distressed debt fund investments, and 2 fund investments that fall within the 'other' category.

Within the buyout category, SCERS has generally targeted the middle market segment, with some exposure to the small/lower-middle market. Two-thirds of SCERS' commitments have been to buyout funds that raised greater than $1 billion in capital. SCERS has made one-third (7) of its buyout commitments to funds that raised less than $1 billion, with an average fund raise of approximately $650 million. However, SCERS also received a much smaller allocation to these funds on average, with an average commitment size of ~$19 million. SCERS has been increasing its average target commitment per fund in recent years, to manage the number of GPs and funds in the Private Equity portfolio. For the 2018 annual Private Equity budget, the average commitment target per fund is $45 million, up from $35 million in recent years. However, SCERS is generally not able to secure allocations near the $45 million target within the sub-$1 billion fund universe. Therefore, utilizing a FoF to allocate within the small/lower-middle market buyout segment gives SCERS greater access to a wider variety of GPs.

SCERS Buyout Exposure:

Fund Size	Average Fund Size	Number of SCERS Commitments	Average SCERS Allocation/Commitment per Fund
< $1 billion	$650 million	7	$19 million
$1 billion to $5.0 billion	$2.1 billion	12	$28 million
> $5 billion	$6.2 billion	2	$33 million
		21	

*Average commitment target in 2018 SCERS PE annual investment plan is $45 million

Staff has communicated the balance between implementing a direct private equity portfolio by investing with differentiated GPs with a strong track record and minimizing the number of GP relationships and underlying funds within SCERS' Private Equity portfolio. There are advantages to maintaining exposure to the small/lower-middle market buyout segment of private equity for SCERS; however, doing so exclusively within the direct private equity portfolio would translate to further proliferation of the GP and manager count. A differentiated and efficient solution is to align with a specialized FoF that has a lengthy track record within the small/lower-middle market buyout segment, and which has remained consistent in investing exclusively with sub-$1 billion funds.

SECONDARY INVESTMENTS AND CO-INVESTMENTS

While primary allocations to funds are the most common way to invest in private equity, secondary investments and co-investments are also approaches to investing in the space. Currently, SCERS does not have exposure to secondary investments and co-investments within the direct private equity portfolio. SCERS' vintage year 2006 and 2008 FoFs have some secondary and co-investment exposure, and SCERS makes secondary investments and co-investments in the Real Assets asset class, through the strategic separate account with FoF manager Pantheon Ventures.

Secondary investments are made when an investor purchases the limited partnership interest of another investor in an existing fund. A co-investment is a direct investment in an underlying portfolio company where a private equity manager offers investors the opportunity to invest directly in an underlying company alongside the fund investment, oftentimes at discounted or zero management fee or carried interest. Some of the differences and advantages between private equity primary investments, secondary investments, and co-investments are shown below.

Combined Allocation		
Primary Funds-of-Funds	Secondary Funds-of-Funds	Direct Funds
» Longer Investment Horizon » Access to Top-Tier Managers[3] » Increased Diversification[1]	» Muted J-Curve » Shorter Holding Period » Potential for earlier Cash Returns » Reduced Blind Pool Risk » Ability to Purchase at a Discount	» Favorable Terms and Fee Structure » Accelerated Capital Deployment » Reduced J-Curve

Source: RCP Advisors

An appealing characteristic of a secondary investment is that an investor is able to view and underwrite underlying portfolio assets, which differs from a primary fund investment, which are set up as blind pools where an investor is trusting a manager to build an appropriate portfolio. 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. In addition, secondary investments are often purchased at a discount to NAV.

Co-investments are attractive because they are typically offered to LPs at favorable terms and fees. This can include zero management fee and zero carried interest (there would still be fee and carry at the FoF GP level, but not at the underlying fund GP level). Return expectations for co-investments are higher than that of primary fund investments and secondary investments, making them an attractive component of a private equity portfolio, and similar to secondary investments, they can help lead to accelerated capital deployment and reduce the impact of the J-Curve. Because co-investments are concentrated exposures to underlying fund portfolio companies, they tend to be smaller allocations in a co-investment fund. Therefore, a co-investment fund will have a greater number of positions compared to secondary fund investments and primary fund investments.

The SCERS investment policy statement (IPS) for Private Equity 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.

Within a recommendation to a small/lower-middle market buyout FoF specialist, Staff and Cliffwater would also recommend including secondary investments and co-investments in the mandate.

SMALL/LOWER-MIDDLE MARKET BUYOUT FUND OF FUNDS MANAGER

The universe for dedicated small/lower-middle market FoF managers is small, and Staff and Cliffwater have identified potential managers for this mandate. Staff and Cliffwater are contemplating an overall commitment to a small/lower-middle market buyout FoF manager of up to $100 million that would invest across primary fund investments, secondary fund investments, and co-investments. An allocation of this size would serve as a nice complement to SCERS' overall Private Equity portfolio, as it relates to diversification across private equity segments (buyout, venture capital, distressed debt), and as it relates to diversification across the various segments of the buyout category. A mandate of this size could also potentially secure some concessions on the terms of the fund. A recommendation of a small/lower-middle market buyout FoF mandate would take place according to the implementation protocol identified within the investment policy statement for the Private Equity asset class.

ATTACHMENTS

- Private Equity Small/Lower-Middle Market Buyout Investing Presentation

Prepared by:	Reviewed by:
/S/	/S/
Steve Davis Chief Investment Officer	Eric Stern Chief Executive Officer

Private Equity Small/Lower-Middle Market Buyout Investing

September 19, 2018

SCERS
Sacramento County
Employees' Retirement System

Cliffwater LLC

Overview

- Review of SCERS Private Equity portfolio
  - Direct versus Fund of Funds portfolio
- Small/lower-middle market buyout overview
  - Fit in SCERS PE portfolio
- Secondary investments and co-investments
- Future Considerations

SCERS Private Equity Portfolio

- SCERS Private Equity allocation: 8.2% versus 9.0% target
- SCERS Private Equity guidelines:

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%

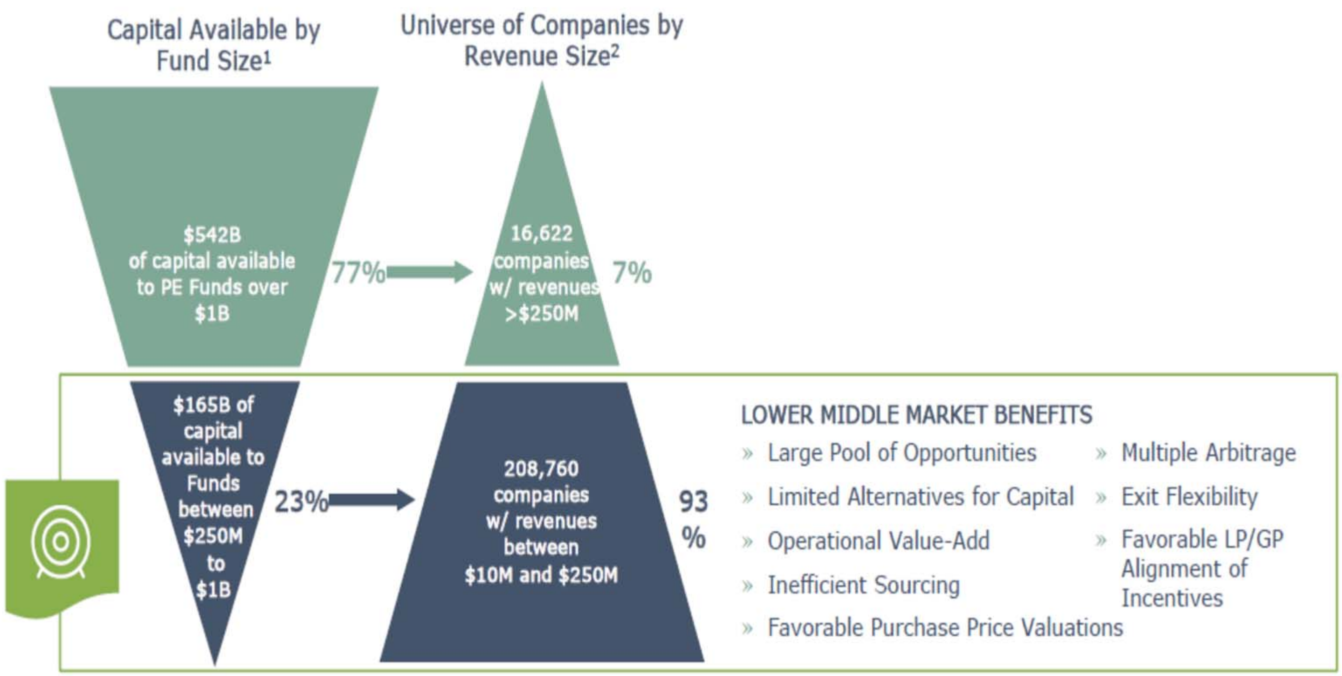
- Fund of Funds (FoFs) early on; direct primary investments since 2011
  - Cliffwater engaged to assist in transitioning from FoFs exposure to investing directly in private equity limited partnerships
- Relationships with 18 General Partners, and investments across 42 funds
- Strong returns on an absolute and relative basis
  - 13.2% net IRR since inception vs. 12.7% for policy index benchmark

Fund of Funds

- A fund that invests in a portfolio of underlying funds rather than directly into companies.
  - The underlying funds in a FoF invests directly into companies
- Currently utilize FoFs in SCERS' Absolute Return and Real Assets asset classes
- PE segments where FoFs can be complementary
  - Small market buyout; venture capital; emerging markets
- FoFs provide added scale and efficiencies
  - Access to diversified portfolio of GPs
  - Complement limited Staff resources
  - Manage manager and fund count
- FoF challenges
  - Extra layer of management fees and carried interest
  - Over-diversification
- Value-add of a FoF has to offset extra layers of fees and carried interest

Small/Lower-Middle Market Buyout

- ❖ Funds raising between $250 million and $1 billion
- ❖ Majority of institutional capital allocates to >$1 billion funds, but larger universe of companies within sub-$1 billion funds



Small/Lower-Middle Market Buyout

- Advantages
  - Less efficient market segment
  - Greater sourcing opportunities
  - Lower entry multiples and debt multiples
- Challenges
  - Larger universe to sort through - greater number of first and second time funds
  - Smaller LP allocations creates portfolio construction challenges
  - Greater variability of outcomes than larger buyout segments
- Returns
  - Upper quartile funds have historically been top performers within broader private equity market, but the segment has generated greater variability in returns

- FoF approach to implementation can mitigate some of the challenges and variability in returns

SCERS Portfolio Fit

- Current private equity buyout construction
  - 21 fund investments to date
  - Average fund size of ~$2 billion
    - Median fund size of ~$1.3 billion
  - Two-thirds of portfolio allocated to >$1 billion funds
    - Average commitment per fund close to $30 million
  - One-third of portfolio allocated to sub-$1 billion funds
    - Average commitment per fund of $19 million

SCERS Buyout Exposure:

Fund Size	Average Fund Size	Number of SCERS Commitments	Average SCERS Allocation/Commitment per Fund
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		21	

*Average commitment target in 2018 SCERS PE annual investment plan is $45 million

SCERS Portfolio Fit

- Future implementation
  - SCERS average commitment target per fund of $45 million in annual PE budget; up from $35 million
  - Challenging to secure full $45 million allocation to sub-$1 billion funds through direct allocations
  - Specialized FoF creates efficiencies by providing SCERS greater access to a wider variety of managers and strategies
    - While managing the number of managers and funds in the portfolio
  - Objective is to identify a small/lower-middle market buyout FoF specialist
    - Resources
    - Underlying GP relationships
    - Lengthy and successful track record
    - Consistent in investing with sub-$1 billion funds.

Secondary and Co-Investments

- Would be included within a small/lower-middle market buyout FoF mandate, alongside primary investments
- Permissible within the IPS for Private Equity
- Secondary investments
  - An investor purchases the limited partnership interest of another investor in an existing fund
  - Visibility to underlying portfolio assets; reduced blind pool risk
  - Reduced J-Curve impact
  - Often purchased at a discount to NAV
- Co-Investments
  - A direct investment in an underlying portfolio company where a private equity manager offers investors the opportunity to invest directly alongside the fund investment
  - Typically offered at discounted or zero management fees and carried interest
  - Higher return expectations than primary and secondary investments
  - Tend to be smaller allocations across a greater number of positions

Combined Allocation		
Primary Funds-of-Funds	**Secondary Funds-of-Funds**	**Direct Funds**
» Longer Investment Horizon » Access to Top-Tier Managers[3] » Increased Diversification[1]	» Muted J-Curve » Shorter Holding Period » Potential for earlier Cash Returns » Reduced Blind Pool Risk » Ability to Purchase at a Discount	» Favorable Terms and Fee Structure » Accelerated Capital Deployment » Reduced J-Curve

Future Considerations

- Contemplating a commitment of up to $100 million to a dedicated small/lower-middle market buyout FoF mandate
  - Smaller universe for specialized managers

- Mandate would invest across primary investments, secondary investments, and co-investments

- Good complement to SCERS' current Private Equity portfolio

- A recommendation of a small/lower-middle market buyout FoF mandate would take place according to the implementation protocol identified within the investment policy statement for the Private Equity asset class.