TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE Item Number: **12**

SUBJECT: CalSTRS Collaborative Model – Private Equity Implementation

CONSENT: ____ ATTACHMENT(S): 0

ACTION: ____ DATE OF MEETING: January 30, 2019 / *20 mins.*

INFORMATION: _X_ PRESENTER(S): Margot Wirth

POLICY

This is a follow-on discussion to the previous agenda item (Item 11). Both of these items (Items 11 and 12) focus on "direct investing" and how to use the "Collaborative Model" to accomplish this type of investing, specifically as it relates to Private Equity.

HISTORY

As was the case for Real Estate and Infrastructure, Private Equity has first presented its vision for a more direct and collaborative investment approach and then is subsequently discussing the particulars related to implementing its vision.

Private Equity's vision for a more direct and collaborative investment approach was presented in closed session in November 2018 (November Item 7) as well as in the preceding open session agenda item (Item 11). It was intended that both of these presentations (one open and one closed) would be made at the November Investment Committee meeting. However, various overruns necessitated that the preceding agenda item (Item 11) be delayed until this month's meeting.

To be clear, this agenda item (Item 12) focuses of the implementation aspect of Private Equity's vision.

DISCUSSION

As discussed in the previous presentations in this series, Private Equity has a well-established team that is capable and experienced in doing both partnerships investing and co-investing. Private Equity argues that there is ample opportunity and significant reward potential associated with expanding the scale and scope of its co-investment portfolio. While there are several other types of non-partnership direct investing strategies that Private Equity does and can envision expanding, in the opinion of staff, increasing co-invest represents the most immediate, largest, and greatest opportunity to reduce costs and increase investment returns.[1]

The existing Private Equity team consists of 23 professional positions (including 18 investment selection specialists and five operations specialist positons). Over the last two calendar years, Private Equity has made new commitments of approximately $6 to $7 billion per year. These figures include approximately ten de novo co-investments per year totaling approximately $500 to

[1] In addition to co-investing, Private Equity is authorized to invest in separate managed accounts, secondary investments, portfolios of diversified investments, and GP ownership interests.

$600 million in new commitments per year. In other words, co-investments have represented approximately 8% to 9% of total new commitments.[2]

At its current investment pace, Private Equity is operating at or near capacity. In order to at least double the program's co-investment run rate capacity in the coming two to five years, Private Equity estimates a need for an additional 15 full time investment professionals as shown below:

	Investment Professionals - Full-Time Equivalents - Private Equity					
	Current			Proposed		
	Partner-ships	Direct[3]	Total	Partner-ships	Direct[3]	Total
Investment Selection Specialists	**14**	**4**	**18**	**16**	**12**	**28**
Operations Specialists	**4**	**1**	**5**	**5**	**5**	**10**
Total	**18**	**5**	**23**	**21**	**17**	**38**

The Private Equity team is currently heavily biased towards partnership investing. In fact, all of the investment professionals currently spend a majority of their time evaluating new or existing partnerships. With respect to co-investing, there are currently four team members that have the requisite skills and experience to lead co-investment deals. These four are currently assigned as either the lead or co-lead on all co-investment deals. These four team members include the Director and three of the six Private Equity Portfolio Managers / Associate Portfolio Managers. These four currently spend, on average, approximately 30% to 50% of their time working on co-investments. Several other team members (at both the senior and junior levels) have garnered co-investing skills and experience primarily from working on the Private Equity team. Approximately one third of the team members have little to no co-investment exposure but the vast majority of these team members have repeatedly confirmed their willingness and desire to learn these skills.

In order to at least double the scale of the co-investment program, Private Equity anticipates significantly increasing both the number and average size of co-investments each year. In

[2] In addition to these portfolio company co-investments, in the preceding calendar year, Private Equity made three co-investments in secondary portfolio transactions involving portfolios of diversified assets. These commitments totaled $ 174 million.

[3] Primarily co-investments.

addition, it is anticipated that the average complexity will increase. Co-investments are operationally intensive and therefore proportionately more of the proposed additional positions are allocated to operations-related positions. In addition to adding operational bandwidth, it is envisioned that several additional positions will be involved in expanding Private Equity's ability to collect and analyze data. These positions are included in the figures above and are distributed throughout the matrix.

Team Structure: Private Equity currently operates with a highly generalized and interchangeable organizational structure. Although there is specialized knowledge amongst the team members, in many respects, all team members are involved in all important matters. For example, all team members on the investment selection sub-team cover a full cross section of the portfolio, encompassing, for example, venture capital as well as buyouts, Asian investments as well as US investments, etc. All Private Equity investment professionals are invited with most members attending the Private Equity Investment Committee meetings that occur several times per month; all attendees are encouraged to participate. All new investment commitments must be approved by a majority of the senior members of the committee (i.e., by the full voting members that include the Director and all of the Portfolio Managers and Associate Portfolio Managers). Private Equity believes that, in the case of the Private Equity portfolio, this highly generalized model has served the program well and that the advantages of team work, collaboration, and knowledge sharing as well as rigorous peer review have outweighed the advantages of more intensive specialization.

This philosophy has been extended in large part but not entirely to the co-investment activities of the Private Equity team. Some team members are more involved in co-investments than others; however, no one is designated as a full-time co-investment professional. Also, it should be noted that due to the faster pace and more specialized knowledge required for co-investing, the Investment Committee for co-investments is limited to a subset of four senior team members.

Private Equity anticipates that as the co-investment program expands, it will eventually become beneficial to designate certain team members as (mostly) full-time co-investment specialists and others as (mostly) full-time partnership specialists. It is anticipated that this will occur in the next one to three years if Private Equity's proposed vision is adopted.

Regardless of the team's organizational structure, collaboration between partnership and co-investment specialists will always be important given the relationship nature of the private equity industry. Those with an in-depth knowledge of the overall partnership will better understand the firm's overall strengths and weaknesses and also play an important role in sourcing co-investments. Conversely, those with the narrower but deeper knowledge of individual co-invest deals will be able to provide valuable perspectives back to those working on partnerships. It is envisioned that newer staff will continue, as they do now, to work extensively on both partnerships and co-investments. It is also envisioned that upper level duties (including Investment Committee participation) will also be shared to a significant degree by senior team members.

Investment Advisors: Private Equity currently uses external investment advisors for both partnerships and co-investments. In both cases, a "dual advisor" requirement is in place which mandates that, for investments done under delegation of authority, that Staff's investment recommendation be matched with an independent third party's concurring recommendation.

Especially with respect to partnerships, Private Equity's investment advisors are highly integrated into the program's business model. It would be a mistake to think of them solely as providers of second opinions. Private Equity team members generally have unrivaled access to the senior staffs of the partnerships in which CalSTRS invests. They know and understand the longstanding portfolio positions in a level of detail that can only be gained by multiple years of observation, inquiry, and interaction. On the other hand, the program's advisors have in-depth exposure to a much wider array of partnerships and industry data. In optimizing the use of these complementary strengths, Private Equity relies heavily upon its advisors for overall industry research, sourcing of potential new investment relationships, operational due diligence and as a source of informed, independent advice (as well as for the aforementioned concurring opinions in fulfillment of the dual fiduciary requirement). This allows Private Equity team members to more fully focus on investment selection, relationship management, investment monitoring, and investment evaluation. Private Equity does not envision any major changes in this arrangement as a result of the contemplated increase in co-investment activities.

With respect to the investment advisors used for co-investments, up until now, these relationships have been much more heavily focused on providing dual fiduciary concurring opinions. From Private Equity staff's points of view, it might be advisable to re-examine the pros and cons of these concurring opinions in regards to co-investments with existing CalSTRS general partners.

<u>Other Considerations:</u> Private Equity believes that the competition for high quality co-investment professionals makes it advisable to budget for a higher average salary for such professionals vis-à-vis private equity professionals in general.

All other factors being equal, Private Equity believes that any directs/co-investment program would be significantly enhanced by being located in a major financial center. Whereas public asset classes are largely research-oriented, private asset classes are more relationship-oriented. In major financial centers, investment professionals have more opportunities to interact and form relationships with other investors, lenders, investment bankers, consultants, advisors, regulators, lawyers and operating company executives. Such an ecosystem is more efficient and is likely to result in a higher level of knowledge, competitiveness and overall flow of opportunity. The Bay Area is an obvious choice to consider. There are many general partners located in the Bay Area (KKR, TPG, Francisco, GI, and many other buyout firms, not to mention the largest concentration of top tier venture capital firms in the world). Also, it should be noted that several preeminent global limited partners have chosen to locate private equity professionals in the Bay Area (most notably Singapore's GIC, and Queensland's QIC).

It should be noted that co-investing often involves acting on deals in a relatively short period of time. Travel of short duration is often required on short notice. This presents many problems which are exacerbated by the current state agency-based travel policies and administrative procedures. Whereas all CalSTRS employees fully support and understand the complete necessity for minimizing travel costs and for having a system with high levels of transparency, accountability and control, Private Equity (along with perhaps many of the other asset classes) recommends that a review be considered to be followed up with potential adjustments and calibrations as seen fit. Staff believes that several existing requirements are out of line with standard industry norms and practices, even amongst governmental entities.

SUMMARY

Via this and other agenda items, Private Equity has presented its vision for an investment program based on a more direct and collaborative investment approach. Additionally, Private Equity has outlined what is required to implement such a vision.

In brief, Private Equity envisions a significant increase in co-investment activity over the medium-term (two to five years). Hundreds of millions of dollars in reduced fees and incentive payments can be realized by building a more sophisticated, higher capacity private equity co-investment program at CalSTRS. It is reasonable to assume that a large portion of these savings will likely accrue directly into higher investment returns. In order to pursue these rewards, additional internal costs will need to be incurred, primarily but not exclusively in the form of additional salaries. In staff's opinion, the incremental costs associated with building out these more advanced Private Equity co-investment capabilities are miniscule compared to the likely rewards. As noted in this agenda item, Private Equity is recommending an increase in staff size of approximately 15 professionals.

In addition to more and larger co-investments, Private Equity envisions gradually doing more complex forms of co-investing. Other limited partner investors have found that, if policy permits, this can eventually evolve into doing deals that are as much direct investments as they are co-investments. Therefore, the advancement of Private Equity's co-investment activities can be seen as a worthy end in itself or additionally as a precursor to doing deals that are of a more purely direct nature. Note that for now, Private Equity is proposing only the former and not the later. Also note that whereas Private Equity does not preclude the possibility, Private Equity does not believe that the program's advancement into doing pure direct investing is inevitable.

Private Equity believes that the theoretical bases for its proposals are sound and that the practical data are also compelling. However as noted in the discussions, there are risks associated with the subject proposal. To mitigate these risks, it is important to be patient and not force a rapid increase in the deployment of co-investment capital when prices are high, as is the case now. Long term focus is paramount.

NEXT STEPS

The three major private asset classes (Private Equity, Real Estate, and Infrastructure) have all now presented their respective visions for more direct and collaborative investment approaches. All three have also outlined their implementation plans for accomplishing these visions.

Looking forward, the CIO, in collaboration with the Investment Committee, will consolidate and adjust these plans as seen fit. With the Investment Committees' continuing concurrence and input, the CIO will endeavor to execute these plans.

ATTACHMENTS/POWERPOINT

Attachments – None

PowerPoint – None