Investment Committee

Item Number 3 – Open Session

Subject: Private Equity Policy Revision – Co-Investments – Second Reading

Presenter(s): Margot Wirth & Robert Ross

Item Type: Action

Date & Time: January 27, 2022 – 50 minutes

Attachment(s): Attachment 1 – Private Equity Policy – Clean Version
Attachment 2 – Private Equity Policy – Redline Version
Attachment 3 – Overview of Private Equity Collaborative Model (1.0, 2.0, and Beyond)
Attachment 4 – Overview of Private Equity Risk Controls
Attachment 5 – Enhanced Portfolio Risk Report – Sample
Attachment 6 – Delegation of Authority Summary
Attachment 7 – Meketa Memo

PowerPoint(s): Private Equity Policy Revisions – Second Reading

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POLICY

The CalSTRS Private Equity Investment Policy (Teachers' Retirement Board Policy Manual, Section 1000, Page H-1), which governs the management of the Private Equity program, seeks to ensure that a portfolio of private equity investments is developed to meet the California State Teachers' Retirement System's return objectives within acceptable risk parameters.

PURPOSE

Staff is proposing policy changes designed to accomplish the following:

- Increase Private Equity's delegation of authority limits to accommodate the increased and growing size of the Private Equity portfolio.
- Enable Private Equity's co-investment program to continue evolving and advancing by permitting more types of co-investing and streamlining processes (essentially moving from Collaborative Model 1.0 to 2.0).
- Make other miscellaneous improvements, updates, corrections, and clarifications.

This is the Second Reading. Changes from the First Reading (presented in July 2021) include:

- The currently proposed policy (Attachments 1 and 2) now expresses delegation of authority limits as percentages of the Private Equity portfolio Net Asst Value (NAV) rather than fixed dollar amounts. Such a framework provides a self-adjusting mechanism to change the limits automatically as the portfolio grows (or contracts).
- The prior policy proposal removed the requirement that an Independent Fiduciary be used for all co-investments. This Second Reading proposal omits that change.

BACKGROUND

The Private Equity program continues to evolve due to the implementation of Collaborative Model, growth in the portfolio and expansion of the team. As the portfolio and investment strategy has become more complex, the team has focused on further developing the appropriate decision-making processes, due diligence procedures, and risk management systems to expand in a progressive yet prudent manner. This report section focusses on the underlying developments in the Private Equity program that are driving the need for the proposed policy changes. Technical descriptions of the proposed policy changes are included in the report section following this one (see Detailed Discussion of Proposed Policy Changes).

Growth in Private Equity Program Size: Delegation of authority limits for Private Equity were last increased in November 2017. Since that time, the NAV of the Private Equity portfolio has more than doubled (from $17 billion to $45 billion) and the co-investment portion of the portfolio has increased seven-fold (from $1.2 billion to $8.4 billion). Over the next five years, the Private Equity portfolio is projected to grow an additional 25% to $54 billion and the co-investment portion of the portfolio is projected to grow 100% to $15 billion.

Given these factors staff believes that increases in delegation authority are appropriate and beneficial to the program.

Collaborative Model Vision for Private Equity: For Private Equity, the Collaborative Model currently manifests itself primarily in terms of increased co-investing. Prior to 2018, Private Equity's co-investment program was highly opportunistic and sporadic, operating with limited, non-dedicated resources. With the advent of the Collaborative Model, it was recognized that Private Equity's relationships, reputation, and domain expertise presented an opportunity to dramatically cut the cost of fees and incentives (and thereby increase net returns) by significantly expanding co-investment activity. In planning for the Collaborative Model in 2018, there was broad consensus by the Investment Committee to dramatically increase co-investing activities and to position the program for potential further advancements regarding direct investing strategies. Backed by the Investment Committee's and the overall CalSTRS organization's commitment to the effort, staff has successfully executed the Collaborative Model 1.0, having built out the team's size and capabilities while delivering both substantially increased co-investment volume and strong performance.

As envisioned, staff has built a highly diversified, high quality co-investment portfolio and has become among the "co-investors of choice" for several elite, highly coveted general partners. The team has been built out and augmented with professionals having specialized co-investment skills gleaned from work experience at an array of well-known and respected investment organizations (see below). An integrated deal sourcing engine (employing both partnership and co-investment specialists) has been built, resulting in outstanding deal flow. Analytical practices have been honed with the mantra of "think like a general partner". With the provision of more resources over the last few years, transaction analysis is much more thorough and sophisticated, both quantitatively and qualitatively, with a view towards executing Collaborative Model 2.0 and beyond.

Private Equity has now committed approximately $11 billion to over 190 co-investment structures. As of June 2021, Private Equity co-investments have delivered a five-year IRR return of 27.1% compared to 18.9% for partnerships. These net returns are above our base case models where a diversified co-investments portfolio is expected to provide net returns of approximately 16% versus 12% for private equity partnerships. Also note that the excess returns of our co-investments over partnerships of 8.2% also significantly exceeds expectations of 4.0% so far.

Given the evolution of the program and progress to date, staff believes the team is in an excellent position to extend its efforts to Collaborative Model 2.0 (CM 2.0). The long-term vision is to progressively expand the opportunity set with increasingly more direct options as shown on Attachment 3. In CM 2.0, the Private Equity program seeks to achieve these three objectives: (1) Target co-investment pacing at 25%-35% of overall Private Equity annual commitments; (2) Develop a program to co-invest with non-CalSTRS partners; and (3) Co-lead co-investments at up to 49% ownership. Staff believes that both Collaborative Model 1.0 and 2.0 (both focusing primarily on co-investments) represent excellent risk-reward profiles for the Private Equity program. To continue with the Collaborative Model's successes and expand upon them, staff believes that increased delegation authority and more co-investment program flexibility are now required.

Team Expansion: CalSTRS Private Equity has a longstanding and strong reputation in the industry for staff excellence and stability. In endeavoring to expand the team, much care has been taken to recruit highly skilled professionals who bring complimentary skills but who also display the utmost in terms of character, teamwork, intellectual openness, and diligence. When recruiting for higher level positions, internally administered case study exams have been added as standard recruiting procedure. Increasingly, executive recruiters are being employed.

Since 2018, Private Equity professional staff positions have increased from 18 to 35 with particular emphasis being given to bolstering co-investment-related skills (e.g., co-investing, mergers and acquisitions, investment banking, and valuation). Over the next three years, the Private Equity program is forecasted to expand to 41 professional positions. Since inception in 1989, Private Equity has made over 760 private equity commitments totaling over $90 billion (including the co-investments discussed above). Whereas some senior staff members have been involved with a large proportion of these capital deployments over the program's history, others

have joined the team more recently from other well-respected institutions, bringing additional industry experience, insight, and institutional strength to CalSTRS Private Equity.

Risk Controls and Reporting: There are a broad array of risk controls and reporting practices throughout the Private Equity investment process which help to ensure that the program is run in a controlled, well thought-out, professional, and prudent manner. In accordance with best practices, interlocking systems and safeguards are in place which employ features such as formal committee approvals, required upper-level approvals (e.g., CIO/DCIO level) for new commitments, written documentation, multi-level party approval for outgoing cash flows, intensive monitoring practices, separation of duties, external reporting, third party validations and policy limits. See Attachment 4 prepared by CalSTRS Investment Services Team.

Also note that the CalSTRS Risk Team has developed additional metrics related to diversification and other factors which will soon be adopted into the Investment Committee's Portfolio Risk Report included in the CIO Board report. See Attachment 5.

DETAILED DISCUSSION OF PROPOSED POLICY CHANGES

The more substantive policy changes are discussed below. Less substantive policy changes are explained in the annotated redline version of the proposed new policy (Attachment 2).

Increase Delegation of Authority Limits: The proposed new delegation limits are summarized in Attachment 6. For example, LP commitment limits are 4% and co-investments 2% of the total Private Equity NAV. The proposed changes represent approximately a two-fold increase in delegated authority for partnerships and a three-fold increase for co-investments (broadly consistent with the First Reading proposal based on fixed dollar amounts when converted to the same basis). The proposed delegation limits might seem large on an absolute basis but in the context of the size of the Private Equity program, the recommended changes are relatively modest. The changes are expected to significantly increase the opportunity set, which Private Equity staff will continue to execute consistent with its historical approach of building a diversified portfolio and with its patient and prudent approach to expanding the portfolio. All Private Equity commitments are approved at the CIO/DCIO level, providing an additional layer of review outside Private Equity's investment staff.

The proposed delegation limits follow the existing policy pattern in that single asset investments are generally assigned delegation limits that are half the size of the delegation limits for investments that are composed of diversified pools of investments.

Note that approval limits for capital calls (cash transactions) of previously approved commitments will remain the same and are outlined in Attachment B of the Investment Policy Management Plan (IPMP).

Permit Co-investing with General Partners Outside of the CalSTRS Portfolio: Currently, Private Equity is restricted to co-investing with only existing general partners. Whereas staff intends to continue this as the overwhelmingly preferred method of sourcing co-investments, staff believes that in a limited number of cases, it makes sense to co-invest with general partners

outside of the CalSTRS portfolio. This is consistent with other world class co-investment programs and provides Private Equity greater flexibility to evaluate a broader range of opportunities, including those which may be offered by prospective general partners that are in the investment pipeline on the partnerships side. Staff is proposing that co-investments can be made alongside both existing and non-existing general partners and other institutional investors, While CalSTRS program has the expertise and resources to accomplish this goal, staff recommends that if a co-investment is made alongside a non-existing general partner, it must be approved by a PE Program Advisor (PEA) or Independent Fiduciary (IF). This will add a small level of additional costs to these co-investments which will be built into the analysis of the transactions. Staff believes this is a prudent approach as we gain institutional knowledge and experience in the beginning but over the long-term with the benefit of greater institutional experience these PEA and IF approvals will not be necessary.

Expand Permissible Terms of Co-investments: Staff recommends removing an unnecessary provision of the policy that stipulates Private Equity co-investments must be made on the *"same or better terms as provided to the limited partnership"*. This stipulation has precluded Private Equity from participating in a potential investment with a lower return (than the limited partnership investment), but with stronger downside protections (e.g., preferred equity vs common equity). Also note that staff is proposing that rather than being limited to investing an amount equal to that of its co-investment partner, that staff be limited to a maximum participation of 50% in any financing round. This provides more flexibility but still limits the program to non-control investments.

Provide More Flexibility with Respect to Co-investing with and by Special Mandate Managers: Staff recommends providing our Special Mandate managers the ability to invest in Collaborative Model investing strategies by allowing them to create co-investment programs and invest in secondary market transactions with their partners. The Private Equity policy is currently unclear with respect to co-investing in the Special Mandates program. Staff believes there are many opportunities to co-invest alongside emerging managers, which technically are CalSTRS general partners. The intent is to increase overall returns while reducing fees and carry for the program. Additionally, staff believes that CalSTRS should be able to directly co-invest with the underlying fund managers in their portfolio companies, therefore Staff is proposing to be able to co-invest with those same managers using the existing co-investment portion of the policy but limiting the maximum size to $100 million given both the size and stage of these emerging managers.

Update the Diversification Section of the Policy: In accordance with policy, Staff periodically reviews and updates the ranges and targets (interim and long-term) with respect to sub-asset type and geography to make sure they are consistent with current strategy and consistent with where staff is finding the best investment opportunities. A few updates / clarifications regarding the mechanics of this have been suggested in the redlined policy. One issue addressed is that the geographic diversification metrics as established in the policy do not match what the data custodian (State Street) tracks. Specifically, whereas the policy currently delineates three

geographical regions, the data custodian generally analyzes investments as being only U.S. or non-U.S., which staff also recommends.

Update the Reporting Section of the Policy: The Reporting Section of the Private Equity policy lists the reports to be provided to Investment Committee for review. A policy change is proposed to clarify who is responsible for developing and presenting which reports to the Investment Committee. Staff is responsible for the program's vision, strategy, and progress, and provides this information in the form of a business plan, pacing plan, and manager ratings report. The Private Equity Board Consultant reports on Private Equity performance as well as industry trends, both of which are included in their semi-annual reports as well as any additional information requests from the Investment Committee.

RECOMMENDATION

Staff recommends that the Investment Committee approve the proposed policy revisions. Attached is a concurring opinion from Meketa (Attachment 7).